DISCUSSION OPTIONS ON THE UNRELATED BUSINESS INCOME TAX

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

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DISCUSSION OPTIONS ON THE UNRELATED BUSINESS INCOME TAX

MONDAY, MAY 9, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, DC.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press Release of Thursday, April 28, 1988]

The Honorable J.J. Pickle (D., Texas), Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Announces the Release of Public Comments Received on Discussion Options Relating to the Unrelated Business Income Tax and the Scheduling of a Hearing

The Honorable J.J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, today announced the release of a committee print entitled, "Written Comments on the Discussion Options Relating to the Unrelated Business Income Tax." The document contains written comments submitted to the Subcommittee, as requested in Press Release No. 16, dated March 31, 1988.

The Subcommittee has requested the Superintendent of Documents to make the committee print available for sale to the general public. The document is available at the Government Printing Office (GPO) Bookstore [(202) 275-3030] or by mail from the Superintendent of Documents, Washington, D.C. 20402. The GPO has established the price of the 960-page document at $25.

In addition, Chairman Pickle announced that the Subcommittee will conduct an additional hearing to complete its review of the public written comments regarding the unrelated business income tax discussion options. The hearing is scheduled for Monday, May 9, 1988, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10 a.m.

The following organizations have been invited to testify at the hearing: The Department of the Treasury; Internal Revenue Service; Office of Chief Counsel for Advocacy, U.S. Small Business Administration; Independent Sector; National Assembly of National Voluntary Health and Social Welfare Organizations; American Council on Education; National Association of College Stores; America Art Alliance; American Hospital Association; Association of American Medical Colleges; Business Coalition for Fair Competition; Small Business Legislative Council; National Federation of Independent Business; Aldrich, Eastman & Waltch, et al.; Association of Business Publishers; Underwriters' Laboratories, Inc.; American Institute of Architects; American Society of Travel Agents; and, Health Industry Distributors Association.

In announcing these latest Subcommittee actions, Chairman Pickle stated: "The response to the Subcommittee's request for public comments on the unrelated business income tax discussion options was impressive. The Subcommittee received thorough analyses of and extensive comments on the list of discussion options both from the non-profit sector and the business community. I appreciate the time and effort of everyone involved.

"The hearing will serve as a supplement to the written materials submitted to the Subcommittee and provide Members wtih an opportunity to raise remaining questions and issues with representatives of all interested parties. I am hopeful that following this hearing, the Subcommittee will be able to complete its deliberations on this important area of our Federal tax law."

Details for submission of written comments:

Written comments previously submitted pursuant to press release No. 16 should not be resubmitted. However, persons wishing to submit written comments for the printed record relating specifically to the May 9 hearing should submit six copies by the close of business, Monday, May 23, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

See formatting requirements below:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The subcommittee will come to order.

We are going to ask our guests to take a seat. There are seats available in the chamber. We would ask you to please take a seat.

I appreciate the volunteered attendance here this morning. We have several witnesses, and we will try to make as much progress as we can today. And we're going to proceed with the testimony of all the witnesses.

I might say that we have had over 400 different responses when we asked for written comments on this subject. So we note that with considerable interest.

Today we are talking about the series of discussion options, that is what they are, on the unrelated business income tax. The subcommittee solicited public comment on the discussion options, and we received over 400 responses. The hearing today is designed to supplement this public written comment process. All of the comments received on the discussion options serve as the basis for today's hearing.

The hearing today is being held specifically to provide a cross section of interested parties with an opportunity to submit additional views and to provide members of the subcommittee with an opportunity to question representatives of the tax-exempt and business communities about various options under the subcommittee's consideration. You might call this hearing, "Everything you always wanted to know about UBIT, but were afraid to ask." Today's hearing will bring us closer to reaching the conclusion of the subcommittee's work.

Our efforts in examining the income-producing activities of exempt organizations and the operation of the UBIT started almost a year ago—with 5 days of public hearings, beginning on June 22, 1987. Our request for information on the UBIT began even earlier—on September 12, 1986, when we released a detailed press release outlining the scope of the subcommittee's review.

Release of the discussion options for public comment already has had one desirable effect. The subcommittee is receiving the kind of information that it had expected to receive last June. I especially commend all those groups in both the nonprofit sector and the business community for the seriousness with which they responded to the subcommittee's request for comment on the discussion options. We have reviewed and are analyzing each and every written statement.

The subcommittee's review also has had another desirable effect, or at least an interesting result. We understand from the Internal Revenue Service that unrelated business income taxes paid for in 1987 have more than doubled in comparison to last year—an increase from $55 to $120 million. This is a result of either better compliance by tax-exempt organizations, or a dramatic growth in income-producing activities subject to the tax, or both.

Let this final hearing underscore this new spirit of cooperation and increased disclosure. We are here to determine ways in which the rules regarding the unrelated business income tax can be clarified, strengthened, and updated. We have a fine selection of witnesses representing all the interested parties. Thank you all for coming. In this effort, we are all serving the public interest.

And now let me recognize Congressman Schulze and other Members for any statement they may wish to make.

Mr. SCHULZE. Mr. Chairman, last year we heard more than 200 witnesses testify at 5 days of UBI hearings. Those hearings established a factual record of the income-producing activities of tax-exempt organizations. There was critical evidence that some groups were pursuing income-producing activities so aggressively that they were unfairly intruding into the traditional markets of full profit business.

Since last June we have been able to review and evaluate detailed testimony at the hearings. We have had followup contacts with some of the witnesses from last year. We also have heard from other interested groups in Washington and from groups in our home districts. All of this activity has been helpful in clarifying and refining our analysis of the issues.

The outgrowth of this process was a list of discussion options that the subcommittee released on March 31. I want to thank all persons who filed written comments. The public comments helped us evaluate the effect of the discussions options in the real world operations of tax-exempt organizations and for-profit businesses. The discussion options show that the subcommittee is serious about pursuing meaningful UBI reform but that we do not want to act hastily or isolated from public feedback.

Mr. Chairman, I want to take a minute to say we should not give the wrong impression about the behavior of most tax-exempt organizations. Most tax-exempt groups conduct their affairs in a responsible manner. The aggressive action of a limited number of groups should not overshadow the proper conduct of most tax-exempt organizations. Some persons contend we should not pursue UBI reforms if there are only a few bad apples in the tax-exempt barrel.

My concern is a few bad apples can contaminate the entire barrel if they are not dealt with in a timely, firm manner. Responsible managers of tax-exempt organizations may follow the lead of the aggressive managers if nothing is done to keep the aggressive managers in check.

Mr. Chairman, the subcommittee must ask itself the following recurring questions: Are the discussion options headed in the right direction, with the possible need of only fine-tuning adjustments, or are the discussion options in need of more substantial changes? In written comments in today's testimony, it would be helpful to us in answering these questions.

Mr. Chairman, I look forward to receiving today's testimony.

Chairman PICKLE. Any other members have any statements to make at this beginning point?

Then our first witness——

Mr. RANGEL. Mr. Chairman, I want to congratulate you for the courage you displayed for going into this sensitive area of unrelated business tax and to point out that this, as in other areas that are very sensitive, and you provide the leadership and recognition that the Congress, and especially this committee, has an obligation to make certain that there is a sense of fairness in the taxes.

This is a very complicated area that we are reviewing today because under this administration there has been such dramatic reductions in support for domestic programs, thus, the President has indicated he expected volunteer tax-exempt nonprofit organizations to fill the gap. Many of the nonprofit organizations have been very creative in how they have raised income in order to attempt to achieve their goals. I think it is clear that were this relationship to the business and the objective stated in the corporate charter that the country supports that. But where we find that there is unfair competition for businesses that appear to be unrelated to the profits, we have to look into that.

I recognize many of the options we are looking at today are really options and would advise the nonprofits to assist us in trying to decide which is the fairest and most equitable way to deal with this problem.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Rangel. Any other members? We may proceed to hear our first witness. We will ask O. Donaldson Chapoton, the Assistant Secretary of Tax Policy, to present a statement on behalf of the Department of the Treasury. We welcome you here again, Mr. Chapoton.

STATEMENT OF HON. O. DONALDSON CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), U.S. DEPARTMENT OF TREASURY

Mr. CHAPOTON. Thank you very much, Mr. Chairman.

We have submitted a complete statement for the record. I would like to summarize that statement briefly, and then would be happy to answer any questions.

Chairman PICKLE. Your entire statement will be included in the record. We hope, though, that you take such time as you need, because you had made some general recommendations to us 1 year ago. If you need a little extra time, we will grant that to you, sir.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Let me start out by saying that I would like to commend this subcommittee for its work in the UBIT area. I think it is highly important. This is the first significant review of the UBIT area of tax-exempt entities since 1969. The situation in the tax-exempt area and the UBIT area is not generally one of revenue raising. We don't think there is a great deal of revenue to be raised in these measures, but we think they are highly important nonetheless for the regulatory role of tax laws, for being sure that the tax laws are applied properly to entities that are entitled to tax-exemption and not used to exempt entities not entitled to tax exemption.

It is a question of public perception, taxable entities seeing taxes not being paid by other entities. It degrades the respect of the tax law. We think this area, for that reason alone, is worthy of considerable attention.

The June hearings have focused attention on the UBIT area. As I have indicated, that is a constructive process. The option papers, which this subcommittee prepared, are the next step in that process. Our testimony addresses these options, but we do not adopt them in whole one way or the other. We will deal with the specific options one by one. Since they are not being submitted as a legislative package, we won't address them in that fashion until a legislative proposal is submitted. When one is submitted, which we think will be the ultimate outcome of these hearings, we would suggest administrative considerations relating to the various options proposed will be highly significant. I know the IRS will testify shortly after I do. We have worked closely with them. We think that administrative concerns that might be raised by various options need to be considered along with the policy considerations.

My testimony is divided into two parts. The first part deals with the policy considerations, the broad policy rationale for the UBIT rules; the second part, with the individual options contained in the committee's options list.

Let me summarize my conclusions, which I will get into in just a little bit in more detail. We think that Congress should address the broader questions raised by tax exemption with improved data. We support the proposals for generating additional data. There are a number of these proposals raising considerations that are not on the table for the subcommittee today.

We think that that is appropriate, but we think increased data collection would allow these additional considerations to be studied in the future and some action taken if that study shows that it is necessary at an appropriate time in the future.

Second, we point out that the purpose of the UBIT is not directed solely to the question of unfair competition. The UBIT serves the purpose of enhancing the efficiency of the Government subsidy that is represented by the tax exemption, and also we think the

UBIT performs the purpose of ensuring the accountability of the tax-exempt organizations to the tax system as a whole.

Third, our conclusion is that the general approach of the options is sound. For the most part, these options leave the basic structure of the tax law intact. They make discrete recommendations for change where information is available and, where based on that available information, it is considered appropriate to do so. By and large, they do not make drastic changes to the tax law as they presently exist, waiting additional study to reach those conclusions or to address those matters.

In some respects, the options make rather substantial proposals, and in some cases we agree with them and in some cases we have reservations about them. And I will explain our views.

Let me first turn to my brief discussion that is in my written testimony on the policy considerations. Stepping back a minute and looking at general principles of the tax exemption and the UBIT rules, we have to realize the purpose of the tax exemptions is to encourage production of certain socially beneficial goods and services that would not otherwise be made available by commercial businesses.

When we encourage such activities, there are questions about what is the most efficient way to do it. Is the tax exemption the most efficient way, is there a need for such exemption where it can be argued these goods are readily available in the commercial world? If tax exemption was not there, would these goods and services be available commercially?

We also have a question about the fact that there are large tax exempt organizations which earn passive income, which is totally tax exempt. This has been the law for a number of years.

And questions can be raised, and have been raised, as to whether tax-exempt income, even passive income of large organizations, is justified under today's circumstances, or whether that needs further study.

And furthermore, whether even in the nonpassive area, commercial activities have been growing in the tax-exempt sector. That also needs to be studied in the long range consideration of these matters.

As I indicated, these broad questions of what is the purpose of exempting income, passive and active income, is not really the subject for the hearings today.

The subject for the hearings is more discrete, the UBIT rules, and how they are working in particular instances. But we do encourage the subcommittee to collect the data. As we say in dealing with the options on data collection, we think these options are very sound, that as data are collected and the matter studied, we will be better able to determine just how the exempt organizations are functioning in the community, whether any other changes to those exempt activities need be encouraged or adopted, or whether the rules as they now exist are working rather well.

On the question of unfair competition, from a policy standpoint, we have heard a great deal about the fact that the UBIT we put in the law originally was intended to address the question of unfair competition. The legislative history does indicate that the concern was the source of the rule.

We think that unfair competition continues to be a major consideration in considering whether the UBIT rules are working properly. But I would caution that there is some considerable economic study and thought in this area that unfair competition can be overemphasized, that while tax-exempt organizations do not pay taxes on their active income or commercial enterprises related to their tax-exempt purpose, they also do not pay tax on their passive income. So from the standpoint of opportunity costs, it is argued that these organizations are not encouraged to act unfairly in dealing with their competitors, because, if they are attempting to maximize their profits, they would, just like a taxable business, consider whether it is more advantageous to go into this commercial enterprise or to invest in passive income. And when weighing those differences, they don't pay tax on either one, and the commercial enterprise, which pays tax on both, has the same opportunity cost analysis of which is more advantageous, the commercial activity or the passive income activity.

On the other hand, we must realize that this question of opportunity cost is not the sole motivating factor that causes a tax-exempt entity to go into one activity rather than another.

There are other circumstances, such as the desire to produce more in its tax-exempt area. From that standpoint, that is, when the entity is simply concerned not with raising money but with producing goods and services in the area which it feels it is encouraged to do so by its tax-exemption, it can be argued there is unfair competition.

The question of predatory pricing is also raised. That is whether the tax-exempt entity, given its favorite tax treatment from the standpoint of income tax, of tax-exempt bonds it can issue, and of things of that nature, has an incentive to undercut commercial activities and in so doing put commercial activities out of business.

We know there is some argument to that effect. The empirical data is not as good as it might be. But we think this is an area that does require considerable study and considerable attention. And while we cannot reach any hard and fast conclusions on this, we simply say that it needs to be considered, and that there are other factors such as the opportunity cost analysis that I have alluded to, that suggests that perhaps the unfair competition argument has been emphasized a bit more than justified in some circumstances.

Turning from the unfair competition point, we think that we must also consider the efficiency of the tax subsidy which the tax-exemption represents.

Obviously, the purpose of the tax exemption is to encourage a tax-exempt entity to go into certain areas unfettered by tax. If it engages in commercial activities where the goods and services can be obtained in the taxable sector, we can hardly say it is an efficient governmental subsidy to exempt those activities.

The UBIT rules do play a major role in causing the law to be more efficient, and thus the tax subsidy be more efficient.

Also, there is a question of accountability. We think that where a tax-exempt entity can engage in commercial activity, it can rely less and less on its donors for support. And the donors, we think, furnish a major factor in the accountability of a tax-exempt organization for its activities.

If an organization's activities are not such that donors believe they are worthwhile and advance its charitable purpose, then the donors will tend to quit contributing to the organization, and that will be self-policing.

If the UBIT rules are relaxed, the organization can earn commercial money and need its donors less, then there is a very significant question as to whether the donors, by reducing their support, can have this policing effect and cause the tax-exempt entity to perform a charitable function well and efficiently, rather than to get into other activities.

In this regard, I also ought to mention that we think and have alluded to it in the testimony that information and disclosure to the public and to donors in particular is very important from the standpoint of accountability.

The 1987 Tax Act increased that by requiring forms 990 to be made available for public inspection, as well as the application for exemption by a tax-exempt entity. We think that sort of disclosure to donors is very valuable.

And perhaps this committee should consider increasing disclosure requirements because we are concerned that the mere fact of a Federal tax exemption might lead some donors to think it is an endorsement by the Federal Government of the management and operations of the tax-exempt entity.

While we know that is not the case, we think that full disclosure of information by the tax-exempt entity would help dispel any such notion by the general public or by donors in particular.

Chairman **Pickle**. Mr. Chapoton, let me interrupt you. This committee has recommended in the discussion options certain considerations or changes in the current law. We think these discussion options should be our starting point. Specifically on the area where we said we would retain the substantial related test for UBIT. Then we list a category from A through B–10 categories.

Are you going to comment on those categories, such as the gift book stores and——

Mr. **Chapoton**. Yes, Mr. Chairman. I was just going to turn to that.

I was not going to comment on every one of them, but I can do so. I was going to comment on what I thought were the more significant ones.

If there were any that I would leave out, I would be happy to comment on.

I was trying to set the stage for the overall policy. I think it is very worthwhile to keep in mind what the policy of the UBIT, what purpose is that UBIT serves in considering each of these options. I have set out in some detail in the testimony the policy considerations that I have just referred to. But I will not turn to the discussion options.

Mr. **Rangel**. Mr. Chairman.

Chairman **Pickle**. Mr. Rangel.

Mr. **Rangel**. Would Mr. Chapoton, while he reviews the options, give his opinions as it relates to sound tax policy with some of the problems that we have here, those that deal with the question of fairness and unfairness, and the competition so that as you review the option you could share with us the priorities that we should concentrate on?

Mr. CHAPOTON. Yes, Mr. Rangel. I will try to do that in referring to these specific options.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. CHAPOTON. When I talk about this, Mr. Rangel, it would be both the policy questions. And in many cases administrability questions, because some of these concepts are difficult to administer. That must be taken into consideration, as well as policy.

Mr. RANGEL. Thank you.

Mr. CHAPOTON. I will turn to the various policy options, the first one being the substantially related test. The committee's option is to repeal the substantially related test and replace it with a directly related test.

We understand the frustration and concern about the directly related test and the need to consider some alternative test. However, we have a considerable problem with changing simply from substantially related to directly related. We are afraid that such a change does not add significantly to the uncertainty that exists now with respect to the substantially related standard.

As you know, the regulations provide that the substantially related test is meant to require that the activity must have a substantial causal relationship to the accomplishment of the organization's exempt purpose.

We think the directly related would not add a great deal to that. We know there is uncertainty, administrative difficulties. We wish we had an easier answer to that.

We would simply say that we should continue to gather more information on this, to study the approved compliance possibilities. And, by gathering additional information, we hope this would provide a basis for review and possible modification of this test in the future.

We do not, however, think the direct test would be a worthwhile improvement at this time.

The next option relates to retaining these tests but determining whether each income-producing activity standing alone is tax exempt. We see the purpose and motives behind that option as very worthwhile.

The concern we have is that some activities standing alone might not qualify for tax exemption even though they are substantially related, and would be worthy of tax exemption, such as dormitories and eating facilities for college students.

Standing alone, these activities probably would not be tax exempt; but they are substantially related to the educational purpose of the institution. Therefore, we think they should be worthy of tax exemption.

We have considered whether there would be other approaches that might bear on looking at specific activities to see if they are, should be tax exempt or should be subject to tax.

One idea we think is worthy of consideration is for Congress to require the IRS to grant exemption on an activity-by-activity basis at the time the exemption is originally granted. By this, I mean the organization would file its request for exemption and would state the activities it intends to engage in.

The IRS would determine whether those activities meet the substantially related test, such as the college dormitories or eating facilities, because they are substantially related to the educational function, or whether they are too far afield and should be subject to the UBIT tax, in which event they would not obtain the exemption.

The organization periodically would reaffirm the accuracy and completeness of this application, so there would be some continued study of this matter to see whether the organizations have gotten too far afield in performing activities, whether they continue to be substantially related and worthy of tax exemption.

Reaffirming exemption does raise a spectre of administrability for the IRS. Thus, it is not something we are proposing at this time. We are raising it as a matter worthy of consideration and further study.

The next option is, if these tests are retained, whether UBIT should be proposed on specific activities enumerated by the committee. The first relates to gift shops and book stores, with a number of exceptions that the committee has included, such as on-premises sales of educational materials related to the organization; hospitals where materials that are sold are generally related to in-patient care; universities where the materials sold relate to education programs or low-cost items, and specific exemptions for certain computer activities.

Generally, we think that there is merit to what the committee is suggesting. But in some respects, we think the proposal is too liberal and suggest it be focused slightly more.

With respect to educational materials, we would think that the tax exemption should cover only materials directly related to education or to the tax exempted activity from an educational point of view, such as museum guidebooks or educational texts, on what the museum has to offer.

But we would not think that this exemption should apply to materials which are primarily decorative or functional in nature. For example, we would exempt, we would think, general history books or low-cost prints of exhibited art but not exempt decorative items such as jewelry, or functional items such as furniture, which is a replica or copies of materials that are in museums, on the theory simply that that is too distant from the educational purpose and that these items are functional in nature and not as directly related to the function of the exempt organization.

With respect to the committee's proposals on computers, we think that is a little bit broad. We would also have some concern with the definition of computers that could be purchased. The committee's suggestion was that students or faculty could make one computer purchase a year on a tax-exempt basis.

We have a concern on what would be within the definition of a computer purchase. And if that definition were satisfied, there would be concern whether that would be too broad, because a student probably only needs to make one significant computer purchase during his tenure at the school.

Many taxable businesses supply the computers for students, and we would think that this option might be a little overly broad and therefore interfere with the commercial enterprise of selling computers.

Finally, the committee options suggest that mail order and other off-premises sales be very restricted. We think that might be a little bit broad. We recommend consideration of treating off-premises sales no differently on-premises sales so long as they meet the criteria of education and are directly related to the the educational function of the institution; that if high-cost jewelry and replica furniture are not eligible, it would not matter whether these sales were made on an off-premises or on-premises basis.

The next one I would like to turn to is the option concerning health and fitness clubs; which is option C.

Chairman PICKLE. You skipped B, the sale and rental——

Mr. CHAPOTON. I did, Mr. Chairman. I would be happy to cover it. The options are very numerous, but I would be happy to cover each one. I am not meaning to——

Chairman PICKLE. You proceed as you wish. We may come back to some of those questions.

Mr. CHAPOTON. B is medical equipment and devices. We are generally supportive of the option proposed by the committee. We would just caution that there may be some definitional problems, that what is available in the community may be difficult to determine sometimes.

But if that can be properly handled, we think the option is very worthwhile. We would also caution that it needs to be phrased so as to not interfere with the hospital's providing new or experimental products which are not generally available in the community. We just want to be careful that that option is not so tightly restricted as to discourage hospitals with experimental equipment.

On health and fitness clubs, we have some concern with the option the way it is phrased. It states that the health and fitness activities should not be eligible, or should be subject to the UBIT unless a program is available to a reasonable cross section of the general public, such as by scholarship or fees based on community affordability.

We think this option presents a worthwhile objective. The concern we have with it is twofold. One is definition. We think it would be somewhat difficult to define what would be a reasonable cross section, what the community, what does affordability mean in many circumstances.

We think that many tax-exempt health and fitness organizations provide a unique service and are different from taxable fitness centers. They provide help in poor neighborhoods, special programs for young, elderly and needy. And they provide spiritual and moral values not available in commercial health clubs.

For those, we think, the tax exemption should be maintained. But we are concerned that other tax-exempt health facilities are quite similar to taxable health clubs. In those cases, we have concern whether the exemption is a little bit too broad.

We think the committee might wish to consider evaluating each facility of a health and fitness organization separately, rather than taking the organization as a whole. That would mean that the IRS could look at each facility, determine whether it met the charitable purpose of the whole organization, such as service to the needy, young and elderly, and things of that sort, to determine its charitable purpose.

And the integration of that particular facility or outlet with the overall function of the organization could be considered in determining whether that facility meets its charitable purpose. But the facility generally would have to stand on its own to determine whether it met that purpose. We think this might be a more meaningful and worthwhile examination of whether the organization, in particular that facility, performed a charitable purpose and would exclude those organizations or those facilities which serve primarily to raise money or perform some other noncharitable purpose.

Chairman PICKLE. Let me interrupt you. If you have some questions about what we mean by "reasonable cross section," or "community affordability," will you submit to us some suggestions you have that you think might appropriately approach that solution?

I understand your point concerning the independent survey, let each organization prove it is serving a charitable purpose. If you have any recommendation for the phrasing of language to address on the first point on defining the tax exemption for health and fitness activities,, we would like to have that.

Mr. CHAPOTON. Fine, Mr. Chairman, I will try to do that.

[The following was subsequently received:]

One possibility would be to define community affordability so as to require that health club membership by income categories parallels the proportion of the community falling in such categories. The definition of the community, however, would need to vary depending on the kind of community, e.g. rural or urban, the kind of public transportation available, housing patterns, etc. Also, the Service would need to have authority to set standards for the kind of statistical showing needed to demonstrate satisfaction of this requirement.

Mr. CHAPOTON. The next option relates to travel and tour services. Generally, we are supportive of the option. We think it draws a reasonable line between educational and recreational travel. We think a clear test is needed, because evaluation of travel as educational is subjective in nature. Therefore, such a test would be helpful.

Option E, dealing with adjunct food sales, is largely a codification of the existing practice. We think it has merit, that a restaurant inside a museum would not be subject to the UBIT for sales of food during museum hours.

But if it sold food to the public during nonmuseum hours, it sounds more like a commercial enterprise and should be subject to tax. Generally, we agree with that option.

Likewise, the option F, dealing with veterinary services, we think that option largely reflects current practice. We think, however, that the exception from measures recommended by the veterinarian board is broad and could eliminate the rule.

Therefore, we would have some reservations about that. But otherwise, we think that the option in general has merit. As I say, it does reflect current practice.

Option G, on hotel facilities patronized by the public, we think that it might be a little bit broad to the extent it might allow organizations to be tax-exempt simply because they are related to an educational institution. For example, a hotel or restaurant which performs commercial services, but does it for training of students.

We think that while such a facility might provide worthwhile training, if it produces a commercial enterprise, or if it is a commercial enterprise and earns money, that merely because it is partially used for training would not in itself entitle it to a tax exemption. Generally, I think we agree with that option as phrased. It reflects the current practice.

Option H, routine testing income. This is also, I believe, generally consistent with the current practice, because current regulations specify that routine testing is not research for purposes of the research exemption. We would suggest some changes to this option, though.

One is to direct it to consideration of the definition of research and create exemptions for organizations whose principal exempt purpose includes testing. We think they should not be subject to taxes because they include routine testing.

We also think the exception for laboratory testing that is part of a training may be too broad, because much laboratory testing could be said to be part of training. That in itself should not furnish the basis for an exemption.

Mr. SCHULZE. On both this and the hotel facilities, do you have any suggestions as to a quantitative solution, a certain percentage used for education; 15, 20, 30 percent? In the hotel activity, what if half the employees are students, or 20 or 30 percent? If not, if you would give some thought to that, because it seems to me some kind of quantitative solution would give surety all around.

It also gives the opportunity for gaming as well.

Mr. CHAPOTON. I understand. I think that is very worthwhile. I have not myself considered that. You are talking about whether some bright-line test, if a certain percentage of it was for educational purposes, that it should be tax exempt.

My main concern is that these are actually commercial activities that are used to train people. While that is a worthwhile purpose, if its primary motivation or primary function is to make money and perform a commercial purpose, it is competing with other commercial enterprises.

Mr. SCHULZE. It seems to me if a university is going to have a course in hotel management, you would need more than just the college professors and the students to run a model hotel. You would need some professional managers, professional people there.

But it is just difficult for me to quantify that. Perhaps it is impossible to do.

Mr. CHAPOTON. Would your suggestion be to quantify the percentage of personnel?

Mr. SCHULZE. My question is whether it is possible to quantify the personnel?

Mr. CHAPOTON. We will certainly do that.

[The following was subsequently received:]

We think that, in order to show that the purpose of the activity was indeed educational, a fairly substantial number of employees, perhaps two-thirds, would have to be students, at both the managerial and non-managerial levels. In addition, there should be a requirement that the number of non-student employees be no greater than that reasonably necessary for performance of the activity. Finally, it would be appropriate to limit the percentage of use by the general public, as opposed to visitors to the school or parents of students, to a relatively small portion of total use, perhaps 25 percent.

Mr. Chapoton. Option I, dealing with affinity credit cards and catalogue endorsements. Under current law, if the income is from rental of mailing lists, it is already subject to tax. If there are other motivations other than from the rental or sale of mailing lists, the answer is simply not clear in my mind.

The question is whether it is exploitation of good will. If that is the case, it probably should be taxable. If the purpose of doing this is for fostering identification to the current donors, perhaps this activity should not be subject to tax.

We think this needs some further study and analysis because the practice is relatively sure, and we are not sure what is the motivating factor behind these practices generally.

Chairman Pickle. Mr. Secretary, let me interrupt you once more. We apologize for doing this. I ask for additional information. You say on the one hand that these affinity cards should be taxed if it represents an exploitation of commercial purposes. You also say you wouldn't tax it if the purpose of affinity cards is fostering identification by members of the organization.

I don't understand the real difference between the two. I would ask you to submit to the committee an example of both approaches and how you differentiate them and why the income is the same on either approach?

I want you to submit to us additional information on that point.

Mr. Chapoton. Mr. Chairman, we would be happy to do it. I would say I share your frustration. We were trying to spell out the opposing arguments. Perhaps we can come up with some examples.

Chairman Pickle. You are saying yes and no. You are waffling a little bit in my view. I want something more specific.

Mr. Chapoton. We will attempt to do so. We think this area will require further study.

[The following was subsequently received:]

Because affinity cards involve royalty payments for use of the organization's name and goodwill and because we have supported an option that would remove the exception to UBIT for royalties for the use of property created by an exempt organization, income from affinity cards could be subject to UBIT under the royalty rule. Nonetheless, as I have indicated, this is a difficult issue and one that depends to a great extent on the degree of involvement of the exempt organization.

Mr. Chapoton. Option J is advertising income. The option would suggest applying UBIT to advertising income and allowing reduction from UBIT only for direct advertising costs. Under current law, advertising costs can be deducted against UBIT income. Advertising income can have allocated to it all direct costs of the publication. And the only limitation is that there be no net operating loss created.

We think this option has merit. Administrative expenses would include selling, designing and advertising, and only a prorated portion of those production and distribution expenses could be allocated against that advertising income.

In other words, we think the current law is too broad, that the concept that the expenses incurred by tax-exempt publication in writing the editorial on the nonadvertising portion of its publication should not be allocated against and deductible from the income earned from advertising.

We are mindful of the complaints raised by these organizations that adopting such a rule would treat them differently than commercial publication enterprises are treated. While we recognize that to be the case, we would simply have to say that this is justified under these circumstances because a tax-exempt organization which engages in advertising for income purposes is actually engaged in two different functions. One is its tax-exempt function, the reading material of the publication. That is an exempt purpose.

The advertising section is related only in the sense that that income is used to defer other costs to reduce the expense. That does not mean it should not be bifurcated for determining what is properly taxable.

Therefore, we would think some rule of the sort that the committee has spelled out or has proposed is logical. We would be generally supportive of it.

Option K, dealing with amusement parks, we think is a codification of present law. Amusement parks may have some educational value, but are secondary to recreational components. We are supportive of that option.

Option L, proposal to apply UBIT to inherently proposed commercial activities. While we see the merit of such a proposal, we think in practice it may be difficult to employ. It could create considerable confusion, because it is difficult, as we are having difficulty this morning discussing it, to determine what is inherently commercial in nature.

We think that if such a broad standard were adopted, it would require a number of specific exceptions and that while such an approach is possible, we think the better approach would be the one the committee is using here.

And that is to consider matters such as options A through L or proposals A through L, to determine whether those aspects of UBIT should be subject to tax and that others not so specifically mentioned remain tax exempt.

Congress has from time to time reexamined the specific activities to see if they should remain tax exempt, such as the 1986 act making insurance activities subject to UBIT. We think making UBIT apply on a case-by-case basis is a better approach than in adopting a general standard of an inherently commercial activity.

Mr. Chairman, that concludes the specific UBIT options A through L. I would like now to turn to options labeled 2 through 10, I believe it is. The first one of those is the option proposing repeal of the convenience exception.

We support this option. We think the convenience exception, as it is now used in practice, is too broad. We said so in our June testimony last year. We really think repealing that exception will not greatly impact tax-exempt organizations as much as might be thought, because in most cases where the convenience exception is utilized there are, in fact, other exceptions to the UBIT, which would cover that same activity and make them not subject to taxation, such as the activities being performed primarily by volunteers, things of that nature. Therefore, while it sounds somewhat drastic to suggest repeal of the convenience exception, we think in practice, it will not have a drastic effect.

In any event, we would support it because it is difficult to justify just on its face.

The next option, 3, is a proposal to repeal the regularly carried on test but to retain the trade or business test. Generally, we do not oppose this option, but we have some concern whether it is the best way to go here. We think the regularly carried on test does have some merit and the option would affect activity typically carried on by taxable businesses on a year-round basis and carried on by tax-exempt organizations only periodically.

Other exceptions, such as donated property or volunteers, could prevent application of the UBIT in cases where the removal of this exception would otherwise, make the UBIT apply. Therefore, we generally think the option is logical and supportable, but we would think it requires some care, if it is to be phrased as it is proposed, just totally eliminating the regularly carried on test and retaining the trade of business test. We think it should be modified so as not to apply to periodical fund raising events, which have no clear commercial analogy.

We would think the mere fact that the tax-exempt performed a function, which might be considered as a trade or business, and in the abstract should make it subject to tax, should not be dispositive if it is an activity in which there is no similar commercial activity. In that case, we do not think it is subjected to UBIT. If the option is so limited, we think that it is a reasonable way of approaching this question of the regularly carried on test.

The next option is option 4; the treatment of royalty income. The option would suggest that UBIT applied to royalties which are measured by net or taxable income, or royalties received by an organization for the use of property if such organization created such property or performed substantial services, or incurred substantial cost with respect to developing or marketing of that property.

Generally we think there is a lot of merit to this proposal. We think that the original concept of royalties and the reason they were exempt for UBIT is they were passive in nature and that because of their passive nature, they should not be subject to tax. However, we think that the option, as stated, is simply a little bit too broad.

In many cases of royalties, it is hard to say they are passive in nature where they are created by an organization, and this has been recognized in the taxable arena as well. Under the personal holding company rules, while generally royalty type income is considered passive in nature, there are exceptions where royalties are generated by the entity in certain functions where they spend a great deal of time. In those circumstances the personal holding company rules do not treat that income as passive in nature.

We think, therefore, that a similar rule is appropriate in the tax-exempt area and would subject these royalties to UBIT if they are measured by net or taxable income or they are royalties that arise from property that is created by the tax-exempt entity.

We would suggest, though, that perhaps the option is a little bit too broad in the sense that it would make all royalty income that violated these two tests subject to the UBIT. What we would suggest is having those tests in place, but saying that if the royalty violated those tests and therefore was not passive, because it was created by the entity, or because it was measured by net or taxable income, because consideration should be given to determine whether another rule would apply so as to make it not taxable, for example, being substantially related to the charitable purposes rather than saying it is thus automatically taxable.

If the activity is generated by the organization as part of its charitable purpose, and that later generates royalty income, we would think a good argument could be made that income should remain tax exempt.

Chairman PICKLE. I believe Mr. McGrath has a question.

Mr. MCGRATH. Just on that point, if a voluntary organization has a clearly taxable ancillary business, which its royalties go substantially toward the motive for its showing, do you believe that those incomes should be taxed? Let's say you plow back every cent from your royalty on a bottle of wine toward some charitable purpose, is that in your opinion taxable?

Mr. CHAPOTON. Mr. McGrath, that gets into really the basic question of whether there should be an exemption generally for commercial activities where the profits from the commercial activity are plowed back into the exempt purpose. We think to exempt it solely on that purpose alone is a little to broad, because this would justify any activity, any commercial activity by a tax-exempt organization, and, therefore, would allow tax exemption and would encourage tax exempts to get into commercial activities, because they wouldn't pay a tax.

We think there needs to be a substantially related type concept, or in the case of royalties, it needs to be passive in nature. Because passive income of tax-exempt organizations is not subject to tax on that theory that they are not out there competing with taxable entities, and, therefore, the lack of competition and the other points I have mentioned would not cause that to create a problem.

Mr. MCGRATH. If it is too broad to administer—and we recognize your problems when it comes to the administration of these tax laws that we implement here—how would you then ratchet it down? It seems that what you have been saying all day is that a lot of these things may either be too broad or in some cases, too narrow, and we should take a look at some of these things on a case by case basis. I don't believe there are enough people in the IRS to be able to do that for all the tax-exempt organizations that are out there in their myriad capacities and businesses.

I am just wondering, are we getting into a situation here where we ought to be looking at tighter definitions or looking at leaving the definitions alone and taking everything on a case-by-case basis to find out whether or not there is an abuse?

Mr. CHAPOTON. I agree with you that if we try to leave it on a case-by-case basis for the IRS to examine every one, there are not enough IRS agents to do that. I think what we need to do, though, is to go very slowly in this area, because the law and the practice have built up over a number of years. Ultimately, where we would like to head is have the definitions of the law sufficiently precise so taxpayers and the IRS could easily understand them. Once we reach that purpose, then perhaps the enforcement and the compliance by taxpayers would not be so difficult.

It is somewhat frustrating though, because we do have the general concepts substantially related and things of that nature. I think this particular royalty circumstance may not be that complex though, because the question of whether the royalty was created by the organization or whether it is measured by taxable or net income, those concepts are there in the taxable area in the personal holding company provisions. So that is an area where I think we could tie to the taxable area and get some help out of it.

But the question of whether if it failed—which we are suggesting—if you fail that test, then you go to the test of whether the creation was a part of its exempt function, I agree. That is again getting to be a somewhat difficult test. But we have concern that if we don't give some leeway there, it will inappropriately pick up some organization.

Mr. McGrath. As it applies to income derived from patents, where is the substantially related test?

Mr. Chapoton. I think there would not be a substantially related test unless a patent simply came out of the organization performing an exempt function. But if it does perform an exempt function, exempt research or some other exempt activity, and a patent results from that, and the entity then collects royalty on that patent, I think there is an argument to be made that that income should not be subject to UBIT. But I think, I agree it is a close question.

Mr. McGrath. Thank you, Mr. Chairman.

Chairman Pickle. Mr. Secretary, as I remember, 1 year ago you made your recommendations in this general area along the lines we have followed, but now you are asking us to more clearly delineate what you mean by royalty and try to give you a little broader definition. The committee will take that into consideration.

Mr. Chapoton. Yes, Mr. Chairman, I agree. In several cases we are revising suggestions we have made that this committee acted on and we worked—as you know, our staffs have worked closely together in dealing with these options. I think we all learned quite a lot from this. In some cases, we have actually modified proposals we made last June.

Chairman Pickle. We will keep in touch closely with you as we consider these problems.

Mr. Chapoton. Thank you.

The next option is option 5, the increased UBIT deduction. Generally, we would think that there is some merit in increasing the UBIT deduction. I believe the option proposal is to increase it to $10,000. We think something of that sort might be appropriate, to $5,000 or $10,000, with phaseout beyond $50,000. Generally, we think a suggestion of increase of that magnitude is appropriate in considering what is the proper exemption amount or the deduction amount.

We think it also might be appropriate to consider, if the committee deemed it worthwhile today, a different deduction for 501(c)(3)'s and other tax-exempt organizations. In other words, distinguish between charities and other tax exempts, but we don't think there is a strong feeling there. It is just that that is worthy of consideration because tax exempts or charities perform a different function, and, therefore, there might be justification of a different deduction.

Option 6 relates to unrelated debt finance income. This area of the law arose from concern about a leveraged real estate investment and we think this concern is justified, but we also have considerable concern about adding complexity to this already very complex area. We think the present rules in section 514 of the code are adequate to deal with most kinds of abusive transactions and, therefore, would be hesitant to suggest that the option should be adopted at this time.

Likewise, with the option pertaining to passthrough entities, it would represent a significant change, and it would impose some complicated recordkeeping rules. Therefore, we think if something of that nature is done, perhaps it ought to be limited to tax avoidance situations such as highly leveraged REIT's, which are substantially owned by tax-exempt organizations.

Option 7 deals with the control issues. Generally we are quite supportive of these options and many of them we touched on in our testimony of last June. One part of the option would modify the definition of control by changing it from 80 to 50 percent. That was a specific item contained in our testimony, and we agree with it completely.

The next would be to extend the control rule where the exempt organization in the aggregate owns more than 50 percent. We think that is a reasonable corollary of lowering the general definition of control to 50 percent.

Next is the proposal that the controlled subsidiary's income could be no less than its UBIT income would be if it were measured separately. We think that is also a very worthwhile consideration. We are not aware of any abuse that exists in this area now, but obviously some abuse could exist simply by a taxable tax-exempt entity having a commercial subsidiary, and to reduce the UBIT income of that commercial subsidiary, dropping a money-losing activity into that, and, therefore, offsetting its UBIT income. We think, therefore, that this option is worthy of consideration.

Finally, the proposal that income and activities of controlled subsidiaries should be aggregated to determine if the primary purpose of the parent is tax exempt, we think is very worthwhile. When there are too many taxable commercial activities being operated by a tax-exempt entity, we are concerned this undermines the primary purpose of the basic organization and turns it into a commercial enterprise with only slight tax-exempt activities. Even in that case, even where it is paying tax on the commercial enterprises, we think at some point that the primary purpose of the parent might be compromised, and, therefore, to determine the primary purpose, we think it would be appropriate to aggregate the income and activities of all of the entities in the group.

Mr. McGrath. Don, on that one, if I might Mr. Chairman, aggregating the income and activities, what sort of distribution would you make between income and activities? Let's say 99 percent of the income comes from one percent of the activity. How are you going to aggregate that and apportion it to whether or not it is unrelated business income or not?

Mr. Chapoton. Questions like that are tough. All we are really suggesting by this concept, though, is to apply current law on an aggregate basis. In other words, treat the tax exempt entity as if it engaged in all of the activities of its taxable subsidiaries so that in determining its principal purpose test, it cannot avoid the principal purpose—the current principal purpose criteria—by dropping the commercial activities into a subsidiary. Because, if we consider that a controlled subsidiary is actually under the direct control and operation of the tax exempt parent, we think that is just——

Mr. McGRATH. I am not arguing that it is not perhaps the right thing to do, but I believe in order to clarify for all the people out there as to what this aggregation would mean, there would have to be some sort of formula and I am not sure that you or we can come up with that kind of formula. That is my only comment.

Mr. CHAPOTON. Well, we will consider that. There are problems right now, of course, with the concept of principal purpose, and it is not an easy one to apply.

Option 8 deals with the allocation rules. The option would propose to allow a deduction against UBIT for a proportionate share of the operating cost of a facility, but not allow deduction for a share of the general overhead of an organization or for depreciation. Generally, we support this option. We got into considerable detail on this in our testimony last June, and we have studied it and worked with the committee staff on this matter. We think it seeks to overturn the *Rensselaer* case in which allocations were far too generous. They were based on time related to commercial activities versus time related to tax-exempt activities, and we think that allocation is simply inappropriate. We think this area definitely needs legislative clarification.

I think the only reservation that I have about the options as phrased is whether to deny that any allocation of fixed cost is appropriate in all circumstances. We are a little concerned that in some cases that might work a hardship because where a field house has been constructed by a university, for example, it might slightly enlarge the field house if it determines that it would allow that field house to be used on some occasions for commercial activities, and when it made that determination, it would be appropriate for that extra fixed cost to be allocated against the income generated by those commercial activities.

Therefore, I definitely think some clarification needs to be effected in this area, that we think some consideration should be given to allowing some allocation of fixed cost in some circumstances such as that. We think though, that clearly the rule as it presently exists, or the uncertainty about the rule, does need some attention.

Option 9, tax information and reporting, generally we support all of these options. The first one calls for expanding the form—perhaps it is best to refer to them directly—expand form 990 reporting requirements to include more reporting on activities and income, which the organization claims to be exempt and revenue sources such as contributions, grants and other funding sources.

We think that would be very worthwhile, and it would help us in gathering more information in determining what other areas need attention. The more detailed reporting on revenue producing activities on form 990, we think also that would be helpful, and some of these obviously we could do under current law. But we think some legislative direction would give us considerable help in this regard, because this is a sensitive area and one which there is not much legislative direction now.

I think generally, Mr. Chairman, without going into each of these options, we do support them all. We think they would be quite helpful, and would give this committee, as it studies this matter in the future—and it will have to continue studying the matter in the future, both from the broader picture standpoint of tax exemption generally, and from dealing with UBIT exceptions that we still find too murky to deal with directly right now. Additional information will be quite helpful.

Option 10 contains several proposals. One is to codify the IRS position that a social club may not reduce its net investment income by losses on sales to nonmembers. We support that because we believe it is inappropriate for social clubs to generate tax losses for use of facilities in transactions with nonmembers or to offset otherwise taxable income in these transactions.

In 1969 Congress acted to tax investment income of social clubs. Reduction of this income by expenses that would be incurred in other events is inconsistent, we think, with that congressional intent.

The next proposal there relates to contingent rental income. Generally we have some concern about this, whether there is really need to do this, but we don't strongly object to the concept. It would change the current rules on exempt organizations to permit them to be treated similarly to the REIT rule, which allows a prime tenant to serve as a conduit for the organization so that by going through that prime tenant and measuring income based on the net income of that prime tenant, the organization would not be subject to UBIT so long as the tenant itself met the test of passive income, not basing rent upon the income or its tenants. We are not sure that there is a considerable need for that proposal, but we have no objection to it.

The same with the next option exempting nonrefundable loan commitment fees from the UBIT. This again would apply the rules that are available for REITs on fees they earn from loan commitment fees or loans and transactions that are not consummated. It would be a liberalization of the UBIT rules, and while we are not sure there is a particular need for that liberalization, we have no objection to it, because we think it is a fair proposal.

The next one relates to modifying the rules applicable to organization testing for the public safety. This exception for organizations that test for the public safety was adopted in the 1954 code, apparently in response to one particular organization that had had its exemption revoked on the basis that it was not a scientific organization. As a result, this specific exemption for testing for public safety was implemented.

The rationale of that specific exemption is unclear to us, and, therefore, we think perhaps these rules should be modified and the committee may wish to consider taxing investment income. The testing income question should be considered and studied, and also we would suggest that perhaps the committee would consider whether the passive income of these organizations should be taxed.

As you know, the (c)(4) organizations are now subject to passive income taxation and there could be an argument made that the same rules should apply to organizations which are engaged in testing for public safety.

The next option relates to modifying the piecemeal UBIT exclusions enacted since 1969. We really have no specific comment on this one, because we are not entirely sure what it deals directly with. As a general matter, we oppose special exclusions for UBIT of the sort that we have talked about today, but we know in many cases it is appropriate for Congress to exclude UBIT from taxation of certain organizations, and Congress, therefore, from time to time may wish to consider specific exemptions. It might be appropriate to consider which exclusions adopted since 1969 are not justified, but that is a broader consideration, and we have not gone down the specific ones to consider each one of them.

Mr. Chairman, that covers all of the specific options. I would like to mention though two other points which are not already covered in the options.

The first is the question of research. There is no specific mention of research. As we suggested in our testimony last June, we think this area of defining research justifies some further consideration. We think clearly there is a worthwhile national policy to support research.

It is very important that general basic research be supported, and it is strongly supported in the tax code both in section 41 dealing with the research created in section 174 dealing with expenses of research and experimentation cost. In both these areas there is an effort to define what sort of research is eligible for favored treatment and we think in the tax exempt area as well as it may be appropriate to consider definitions, because without any definitions, without any more precision in this area, we have some concern whether there is some abuse occurring.

We do not think it is of any great magnitude, but we think given the general benefit available for research in this area, it deserves some attention.

Second, another option not mentioned, we think is worthy of consideration, is one dealing with charitable considerations. We think this area is somewhat abused, in particular where items of value are sold by charities. There is solicitation of a sale of goods and services. These goods and services are sold and we are afraid that in many cases taxpayers are simply not properly treating the tax deduction.

The deduction under current law very clearly applies only to the extent that the money paid by the donor exceeds the fair value of the goods or services which he purchases. This area is not treated very specifically, because there are no good guidelines telling the charities how they should handle these matters.

This is a matter, incidentally, for the UBIT. It is not directly related to the UBIT because it is not a matter for the charities, but it is an area of abuse that is occurring with respect to the donors of the tax-exempt entities. We think perhaps the charitable institutions could be encouraged or required to place some value on the goods or services being sold, and they should be requested to advise the donors only to the extent the payments made by the donor exceeds that value if it is deductible.

In 1987 Congress clarified the rules with the exempt organizations not entitled to receive deductible charitable contributions, and required these organizations to disclose that fact when they have contributions or payments by members or nonmembers. We simply think some consideration should be given to organizations which are eligible for charitable contributions to require them to make a similar mailing or announcement to their donors that would limit the value, limit the deductions only to the extent the value contributed exceeds the services or property received by the donor.

In that same connection, we think it might be worthy to consider where payments are made by donors to tax-exempt organizations and these same donors buy services from these organizations, that some distinction be drawn between the checks written. This could be an alternate proposal to the one I just made or as complementary to that. Consider school tuition. Where a contribution is made to a school, it is clearly deductible. Where a payment is made for tuition, it is clearly not deductible, yet in both cases, the check is written just to the charity and it is not easy for the IRS, it is not easy for the donor, to determine at yearend whether he made a charitable contribution or whether he paid a deductible tuition fee.

We think perhaps some rule spelling out how the checks are written or in some way delineating deductible from not deductible might be worthwhile.

Mr. SCHULZE. Does Treasury think this is a major area of avoidance or a major problem?

Mr. CHAPOTON. Mr. Schulze, we hear a lot about it. Unfortunately, again, like many of these areas, how significant it is from a dollar standpoint is very difficult to determine. It is our perception though that it does create disrespect for the law because people simply ignore these rules.

I think by and large when someone buys something from a rummage sale at a church or a school, they tend to ignore, or they might tend to ignore in many cases the distinction between the fact they got something of value or they made an excess contribution. Similarly, with a dinner ticket for a very worthwhile organization, there is entertainment, and a very expensive meal is served. The law is clear only to the extent the payment exceeds the value of the meal, and the entertainment. Do you get a deduction? But deductibility is not even required to be put on any notice that goes to the patrons, and there is no indication of the approximate value. In some cases, most tend to do that, but there is not a requirement that they do.

Mr. Chairman, that concludes my remarks.

I just realized that earlier in talking about (c)(4) organizations I made a rather strong mistake. I said that the passive income of (c)(4) organizations is subject to tax. That is not the case. Under current law it is tax exempt. We simply suggested in our testimony last June that it might be worthy to consider whether this passive income should be subject to taxation, but the current law says that it is not subject to taxation.

[The prepared statement follows:]

For Release Upon Delivery
Expected at 10:00 a.m.
May 9, 1988

STATEMENT OF
O. DONALDSON CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department on possible revisions to the unrelated business income tax ("UBIT") that are contained in the list of "discussion options" released by the Committee on March 31, 1988. Last June, this Committee held five days of hearings regarding the appropriate tax treatment of income-producing activities of tax-exempt organizations. My testimony today builds upon Treasury's prior testimony before the Committee and reflects our consideration of the hearing record from last June as well as the many constructive comments submitted by interested parties.

Mr. Chairman, both you and the entire Oversight Subcommittee are to be commended for undertaking a fresh look at this important area of the law, one that has not been thoroughly reviewed by Congress since 1969. While tax laws regarding exempt organizations serve for the most part to regulate the sector rather than to raise revenue, the importance of these laws to the tax system as a whole should not be underestimated. Few areas are more important to how the American public perceives the fairness and success of our tax system. Who is not taxed -- and why -- is of the utmost concern to those who are taxed.

Both the hearings of last June and the ensuing public debate have focused a great deal of attention on the structure and administration of the UBIT. The process has been a constructive one in which individuals representing all sides of this issue have been able to express their views fully. At this time the discussion options have not been presented as a legislative package and we are not in a position to either endorse or oppose the entire options paper. With respect to individual options, however, many are consistent with my testimony of last June (the "June testimony") and others address areas that are of concern to us. Although I indicate general support for some of these options, our support of legislation reforming the UBIT would depend on the proposals ultimately contained in such legislation. In addition, we believe the administrative burdens such legislation would place on exempt organizations and the Internal Revenue Service is an important factor to consider. We look forward to working with your Committee in producing legislation that reflects the legitimate concerns of all interested parties.

My testimony will consist of two parts. First, I will describe various tax policy considerations regarding the UBIT, with reference to my testimony from last June. Second, I will comment on each of the discussion options in light of those considerations as well as administrative and other concerns. My conclusions, very generally, are as follows.

> First, the issue of the appropriate structure of the UBIT raises fundamental questions regarding tax exemption. We recommend that Congress address these broader questions, but we recognize there is a need for improved data before such questions can be comprehensively analyzed. Thus, we support the proposal to collect needed additional data and to mandate the completion of certain studies.

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Second, in analyzing the UBIT it is important to recognize that the effort to limit "unfair competition," although the primary motivation for the original enactment of the tax, is not the only purpose served by the tax. The UBIT also serves the important goals of enhancing the efficiency of the governmental subsidy inherent in tax exemption and of helping to ensure the accountability of tax-exempt organizations.

Third, given the need for improved data, I believe the general approach of the discussion options is sound. The options, for the most part, would leave the basic structure of the law intact and make only discrete changes in areas where information available today permits Congress to make informed judgments. A number of discussion options reflect suggestions made in my June testimony and other options reflect a codification of present administrative practice.1/ We are generally supportive of those options. Other options would change present law, in some cases dramatically. While we would support some of these changes, we have reservations about others.

Policy Considerations

I. Introduction

The UBIT is an important element of the rules that define and limit the scope and rationale for tax exemption. Any comprehensive review of the UBIT thus raises questions about the policies underlying tax exemption and how these policies are served in practice. As I stated in my June testimony, tax exemption is intended to encourage the production of certain socially beneficial goods and services that would not otherwise be produced in adequate supply. There are fundamental issues, however, as to whether tax exemption is the most efficient way to encourage desirable activities, whether tax exemption continues to be necessary for certain activities, and whether tax exemption is justified for organizations that rely almost exclusively on commercial activities for support. Further questions arise as to the effect on the tax system and the economy of the growing tax-exempt sector, including both section 501(c) organizations and pension trusts, such as whether the active presence in the marketplace of exempt organizations with substantial assets and no tax on their "passive" investments can create undesirable economic distortions.

Full consideration of these issues will require the development of additional information concerning the activities of the tax-exempt sector. This Committee's hearings and the discussion options have thus appropriately been focused on the day-to-day application of the UBIT and the practical effect of taxable and exempt suppliers co-existing in the same industry. I should emphasize, however, that is important for Congress to review the broader policy issues concerning tax exemption in order to ensure that the substantial benefits of tax exemption are appropriately limited. We, of course, would be pleased to assist in that review.

1/ With respect to several of the discussion options, I state that the option would codify present law or administrative practice. In so stating, I recognize that in some instances the administrative practice of the Internal Revenue Service is being challenged in court and that our view of present law may differ from that of others.

II. Tax Exemption and Unfair Competition

The ability of exempt organizations to conduct income-producing activities without incurring tax liability has led to complaints from the small business community and has provided the impetus for consideration of changes in the UBIT. While complaints regarding unfair competition must be taken quite seriously, and in fact gave rise to enactment of the UBIT in 1950, we believe that tax policy toward commercial activities of nonprofit organizations should not be guided solely by such concerns. The UBIT also serves an important role in enhancing economic efficiency -- not taxing income from some commercial activities of exempt organizations may represent an inefficient use of an indirect government subsidy. Moreover, the UBIT helps to ensure the accountability of tax-exempt organizations, both to individual donors and to society as a whole. Without these other functions performed by the UBIT, it is possible that increased pursuit of commercial income by tax-exempt organizations could change the fundamental nature of the nonprofit sector.

As I discussed in the June testimony, the precise effect of income tax exemption on competition is not entirely clear. There is little empirical evidence regarding either the behavior of exempt organizations in competition with taxable businesses or the response of taxable businesses to such competition. Even though tax exemption allows a nonprofit organization to earn a higher rate of return than a taxable company within a particular activity, some have argued that this does not necessarily create an adverse effect on the taxable business. Because the nonprofit organization enjoys a similarly higher rate of return on other uses of its capital, including passive investments, the relative "opportunity cost" of entering a particular business (which includes the revenue lost from forgoing alternative investments) can be equivalent for taxable and exempt organizations. As a result, taxable and exempt businesses may be in the same relative position with respect to the decision whether or not to enter a particular business. Thus, following this analysis, if income tax exemption were the sole benefit granted to nonprofit organizations, nonprofit and taxable organizations might well co-exist in the same business, just as such organizations co-exist in the stock and bond markets.

Nonetheless, when tax exemption is combined with other governmental subsidies -- such as the ability of some exempt organizations to issue tax-exempt bonds, access to lower postal rates, exemption from certain federal excise taxes, and exemption from certain state and local taxes -- an exempt organization's cost of producing goods and services for sale is further reduced. Hence, its profit is increased without a corresponding increase in the return available from alternative passive investments. Consequently, there exists an additional incentive to produce such goods or services as opposed to making a passive investment.

In addition, as a result of their various cost-saving benefits, it is possible that tax-exempt organizations would reduce their prices in an attempt to drive out non-exempt competitors. Engaging in this type of "predatory" pricing leads firms to forego profits in the short run, in the hope that future profits will be large enough to overcome the near-term losses. There is little agreement, however, among economists about whether such pricing is common or whether it is likely to be successful.2/

2/ A further complicating factor in assessing the pricing behavior of exempt organizations is that they will often be motivated primarily by the desire to maximize the output of their exempt product, not by the desire to maximize profits. This could result in prices of such exempt products that are lower than those of their taxable competitors. The desire to maximize exempt output would depend, of course, on whether the organization views those items as part of its primary exempt function, rather than as part of an ancillary function.

Thus, although the precise consequences are not perfectly understood, the combination of tax exemption with other governmental subsidies may create a competitive advantage for tax-exempt organizations. Such advantage could be sufficient in certain cases to discourage taxable firms from entering an industry or could encourage existing taxable firms to leave the industry. This result is of particular concern if exempt organizations impinge on activities previously carried on principally by taxable businesses. In such a situation, the taxable businesses would not have anticipated competition from tax-exempt organizations and would have made economic decisions ignoring this possibility.

III. Economic Efficiency

In addition to limiting unfair competition, the unrelated business income tax serves the goal of economic efficiency by helping to ensure that the subsidy of tax exemption is used in the manner that provides the greatest social benefit.

The effect of the UBIT on economic efficiency can best be seen by considering the impact of a system that exempts from tax all unrelated business income. Such a tax system would encourage equally the pursuit of exempt and unrelated activities by non-profit organizations. This would be an inefficient use of the grant of tax exemption, in that a subsidy is not needed to assure production of appropriate amounts of most commercial goods and services.

Tax exemption for unrelated business income would also act as an indirect subsidy to the primary exempt function of a nonprofit organization because the organization would direct some or all of its unrelated business income towards its exempt function. Subsidizing the primary exempt function of nonprofit organizations by means of a tax exemption for unrelated income, however, would simply reward those organizations that are most successful in pursuing commercial ventures. Such a system would be unlikely to provide the greatest reward to the most deserving organizations; i.e., those that provide the greatest social benefit.3/

Our current tax system does not, of course, exempt all nonprofit income from taxation. Nevertheless, the criterion of economic efficiency can be applied to those particular areas in which nonprofit commercial activities do, in fact, escape taxation in order to help determine whether such activities should remain exempt.

IV. Accountability of Tax-Exempt Organizations

A third important function performed by the unrelated business income tax pertains to the accountability of exempt organizations. As I mentioned in my June testimony, the rules limiting the scope of tax exemption require a non-profit organization to concentrate its activities on those purposes for which it was granted exempt status.4/ Unrelated business activities can divert an organization from its primary purpose and, in extreme cases, supplant that primary purpose altogether.

3/ The most efficient subsidy would be allocated to various uses so that the social benefit of the last dollar spent on each use is equalized. If this is not the case, then a reallocation of the subsidy, from low to high social benefit uses, would increase total social benefits at the same cost to the government. This goal would be accomplished by redirecting subsidies from commercial to exempt activities, and from those exempt activities with low marginal social benefits to those with higher benefits.

4/ An organization formed under section 501(c)(3) of the Code, for example, must be organized and operated "exclusively" for one of several designated exempt purposes.

Although the Internal Revenue Service has the authority to revoke an organization's exempt status in such cases, it can be extremely difficult to establish the primary purpose of an organization.

Because the Internal Revenue Service does not have the ability to closely monitor the activities of all exempt organizations, and because it has few enforcement tools short of revoking exempt status altogether, some complementary form of oversight is needed to help ensure that public purposes are being served by the grant of tax exemption. At least in the case of section 501(c)(3) organizations, we believe that unrelated donors who support the organizations can help perform this function. If an organization loses sight of its exempt purpose, for whatever reason, donors will eventually cease to support the organization and they will shift their contributions to more deserving organizations.5/

If an organization is able to support itself with commercial activities, however, the role of the donor becomes less critical and the organization becomes less accountable to the very persons who are best situated to evaluate its activities. To the extent these commercial activities are central to the organization's exempt purpose -- such as education -- there is perhaps less cause for concern because Congress has determined that these activities should be subsidized by the tax system. But to the extent such income-producing activities are merely tangential to the organization's exempt purpose, we believe Congress has cause for concern and that the unrelated business income tax can help regulate the extent of such activities.

V. Conclusion

The foregoing description of various purposes served by the UBIT brings several points into focus. First, the existence of unfair competition is not always required in order to conclude that unrelated income from a particular activity should be subject to tax; considerations of economic efficiency and of accountability may independently justify such a result. Second, although tighter tax laws regarding unrelated business income may be desirable, on either equity or efficiency grounds, they would undoubtedly reduce the overall level of government support provided to activities performed by the nonprofit sector. Congress may decide that a reallocation, not a reduction, of the present subsidy for such activities is desirable. Finally, the appropriate scope of the UBIT is part of the more fundamental issue of whether particular activities should be granted tax exemption. When the necessary additional information has been gathered with respect to exempt organizations, we believe Congress should undertake a comprehensive examination of this fundamental issue.

Discussion Options

Next, I will comment on the individual discussion options. My evaluation of each option will in part turn on the purposes of the UBIT I have just described, but will also consider administrative and other concerns.

5/ The legislation enacted as part of the Revenue Act of 1987, which requires exempt organizations to make available for public inspection their Forms 990 and application for tax exemption, helps facilitate an informed judgment by donors in this regard. State laws requiring other forms of disclosure are also beneficial. Indeed, Congress may conclude that additional disclosure requirements are appropriate if further study indicates that donors are not sufficiently informed. We are concerned, in particular, that some donors may incorrectly view the Internal Revenue Service's recognition of exempt status as being the equivalent of a governmental endorsement of the organization's management and operations.

I. "Substantially Related" Test:

"Repeal "substantially related" test and replace it with a "directly related" test."

Under present law, a regularly carried on trade or business is exempt from tax if the business is substantially related to the exempt purpose of the organization, aside from the need for funds. Treasury regulations elaborate upon the meaning of the term "substantially related" by requiring that the business activity have a substantial causal relationship to accomplishment of the organization's exempt purposes, a relationship which "contributes importantly" to the accomplishment of such purposes.

In my June testimony, I stated our belief that the substantially related standard has conceptual merit as the basis for determining the scope of an exempt activity. While we share the concern that the relatedness standard has been applied in an overly generous manner, we do not support replacing "substantially related" with "directly related." Such a change would generate considerable uncertainty and confusion without necessarily changing the substance, or the administrability, of the standard in any significant way.

We remain concerned, however, with administrative and interpretive problems that the substantially related standard has created. Although we do not propose changes in the standard at this time, we do recommend more detailed reporting, as suggested in Option IX, in order to improve compliance and to provide a basis for further review.

"Determine whether each income-producing activity standing alone is tax-exempt."

Unlike the previous option, this option would represent a significant change in the substance of current law. The option has conceptual appeal in that it would limit tax exemption to those activities specifically identified by Congress. Nonetheless, numerous activities of tax-exempt organizations -- including the operation of dormitories, dining halls, and hospital pharmacies -- would likely be taxable under such a test. We believe the "substantially related" standard appropriately exempts many such activities from tax even though the activities would not warrant tax exemption standing alone. While the provision of food and lodging, for example, is not an inherently exempt activity, the operation of dining halls and dormitories contributes significantly to the educational mission of most universities and in our view is appropriately exempt from tax.

Even though we do not support this option because of its effect on certain related activities, we believe the option attempts to address a fundamental problem -- that an organization with exempt status is relatively free to embark on any number of profitable activities that it deems to be related to its exempt purpose. As my June testimony and that of others made clear, the present standard for relatedness may in operation permit activities to be treated as exempt even though their connection to the original exempt purpose is quite tenuous. Although we do not have a specific recommendation to offer at this time, there may be alternative approaches to this problem. For example, Congress could require an exempt organization to identify all activities for which it is seeking tax exemption so that the determination letter issued by the Internal Revenue Service would identify which activities are recognized as exempt, with the letter applying only to such activities. All other significant income-producing activities would remain taxable. In line with this approach, the organization might also be required to reaffirm periodically the accuracy and completeness of its application for exemption.

"Retain "substantially related" test; however, impose UBIT on specified activities (as listed in A-L below) whose nature and scope are inherently commercial, rather than charitable."

"A. Apply UBIT to gift shop/bookstore income [with exceptions for (1) on-premises sales of low-cost mementos, (2) on-premise sales of an educational nature which relate to the organization visited, (3) in the case of a hospital, articles generally used by or for inpatients, (4) in the case of a university, articles in furtherance of educational programs, or low-cost items (dollar cap), and computer sales not in excess of one sale per student/faculty per year]. In addition, apply UBIT to income from all catalog and mail/phone order or other "off-premise" sales (with exception for de minimis sales, in relation to amount of "on-premise" sales)."

While this option would codify certain aspects of present law, it would, to some extent, liberalize present law by making available some clearly defined "safe harbors." With respect to exempt college bookstores, for example, all souvenir items below a certain dollar level relating to the organization would be exempt from tax, but all other non-educational sales would generally be subject to tax. In light of the substantial administrative difficulties the Internal Revenue Service has had in this area, we believe legislative clarification along the general lines of this option is desirable. We suggest that the term "educational" in the second exception be limited to include materials such as explanatory guidebooks or other educational texts, but not include items of a primarily decorative or functional nature. In the case of an art museum gift shop, for example, sales of an exhibition guidebook, a general text on art history or low-cost prints of exhibited art would be exempt. Sales of primarily decorative items such as jewelry would be taxable. Similarly, the sale by an organization devoted to the study of Elizabethan England of an armchair modeled on one used in that era would be subject to tax because of the functional nature of the product. Finally, we suggest that the term "articles in furtherance of education programs" in the fourth exception be limited to exclude common consumer items (such as sporting equipment and cameras).

We have some question as to the appropriateness of a special provision for sales of computers to students. In addition to administrative concerns regarding the necessity of defining a "computer" (which is in fact a system of components) and keeping track of each student's purchases, we question the policy justification for such an exception in light of the multitude of small taxable businesses that sell personal computers. In any event, we are uncertain as to why a student at a four year college would need to acquire as many as four computers -- thus, if this option is adopted, we would suggest a lower limit.

With respect to the application of the UBIT to income from all catalog, mail/phone order, or other off-premises sales, the option as stated may reach too broadly. In certain cases, for example, the use of "off-premises" sales might be the only feasible way of carrying out the organization's exempt function, such as sales of scholarly texts by a university press. In other cases, the use of such sales would be appropriate for events such as a college theatrical performance. Although we are sympathetic to the desire to reach mail order sales that have only a minimal connection to tax-exempt activities, we believe that, if appropriate limitations are developed with respect to on-premises sales, these same limitations should be sufficient with respect to off-premises sales. This is an area where a "bright-line" rule is needed. Thus, sales of items that have a primarily utilitarian or decorative function should be subject to tax whether sold on or off premises.

"B. Apply UBIT to all sales or rental income of medical equipment and devices (including hearing aids, portable x-ray units, oxygen tanks), laboratory testing, and pharmaceutical drugs and goods (with exceptions for (1) inpatients, continuous-care outpatients, or emergency treatment outpatients or (2) items not available in immediate geographic area.)"

This option would apply the UBIT when the purchaser might just as easily go to a taxable supplier of the equipment. Although the concept of a "continuous-care outpatient" is a new one in the tax law, we assume it is meant to include patients who utilize the particular piece of equipment as part of an ongoing program of medical treatment. I would emphasize that we believe the definition of this term should be carefully developed so as not to discourage efforts by hospitals to control costs by performing medical procedures on an outpatient basis whenever possible.

Notwithstanding the interpretive issues presented by the new terms, we are generally supportive of this option, which we believe represents only a moderate tightening of present law. We have reservations, however, about the exception for items not available in the immediate geographic area. This rule would present administrative difficulties in determining the meaning of "availability" and "immediate geographic area." Furthermore, it also would allow an exemption from the UBIT where the same equipment is available by mail or in certain cases in which competition from an exempt organization may have discouraged or eliminated taxable suppliers in the immediate geographic area -- precisely the situation about which Congress is most concerned. Thus, we do not support this aspect of the option, except, perhaps, to the extent an exempt organization is providing new or experimental products.

"C. Apply UBIT to income from certain health, fitness, exercise and similar activities unless program is available to a reasonable cross-section of the general public such as by scholarship or fees based on community affordability."

This option is apparently intended to ensure that health, fitness, and exercise facilities operated by tax-exempt organizations are in fact fulfilling a charitable function.6/ While we agree with this goal, we are concerned that this option would pose substantial administrative problems because of the need to apply terms such as "reasonable cross section," "community," and "affordability." If a health club costs $500 per year, for example, how would the Internal Revenue Service be able to determine whether this fee is "affordable" in a community with an average income of $25,000?

We wish to emphasize that many tax-exempt health and fitness organizations provide services that are fundamentally different from those provided by taxable fitness centers. Exempt facilities are often located in poorer neighborhoods, have special programs for the young, the elderly, and the needy, and attempt to instill spiritual and moral values in their members. Such facilities often do not compete directly with taxable fitness centers for the same clientele.

6/ The option does not indicate whether the term "health" includes activities such as the operation of a hospital. Although hospitals, like health clubs, are eligible for tax exemption if they are operated exclusively for charitable purposes, we suggest that this option not be applied to traditional health care activities of hospitals. Instead, we recommend that hospitals and their related organizations be considered as part of Congress' broader review of tax exemption that we have recommended.

In some instances, however, tax-exempt organizations provide similar services and do compete directly with taxable organizations. If a tax-exempt organization establishes a racquetball or weight-lifting facility in an affluent neighborhood and it is functionally indistinguishable from taxable fitness centers, for example, legitimate questions may be raised as to what charitable purpose is being served. The Committee may wish to consider modifying this discussion option to provide that each fitness or exercise facility operated by an exempt organization must independently serve a primarily charitable purpose in order for that facility to enjoy tax exemption as a charity. This charitable purpose could be demonstrated by a variety of factors, including service to the needy, the young, the elderly, and the community as a whole. The extent to which the facility is integrated with the charitable activities of the organization as a whole might also be an appropriate factor in this determination. Under this modification, programs relating to athletic skills or body-building would not *per se* demonstrate a charitable purpose, unless coupled with other factors indicating charitable intent. If a facility does serve a primarily charitable function, however, all of its income from general membership would be exempt because its activities would be described in section 501(c)(3). Such a standard would recognize the very important contributions made by tax-exempt health and fitness organizations, but would limit tax exemption in those few instances in which the operation of a fitness center serves primarily to raise money or to perform some other non-charitable purpose.

> "D. Apply UBIT to travel and tour services (with exception for services provided by colleges/universities to students/faculty as part of a degree program curriculum, and de minimis sales to non-students/faculty.)"

This option would be fairly easy to administer and draws a reasonable line between educational travel and travel that is primarily recreational. Although the option would no doubt subject to tax some worthy tour programs, we believe that the evaluation of travel as "educational" is so inherently subjective that some clear test is required.

> "E. Apply UBIT to adjunct food sales (with exception for on-premise services and/or sales provided primarily for students, faculty, employees, members, or organization visitors)."

We view this option as largely a codification of present law and administrative practice. As we understand the proposed rule, a restaurant inside a museum would not be subject to the UBIT for sales of food during museum hours if its services are directed to museum visitors. If it is open to the public when the museum is closed, however, or if it caters primarily to the general public, income from such sales would be subject to the UBIT. Presumably concession stand sales at a football game or a symphony concert would remain exempt.

> "F. Apply UBIT to income from certain veterinary services such as grooming, boarding, and elective surgery (with exceptions for spaying and neutering, measures to protect the public health, and measures recommended by a veterinarian for the health of the animal)."

This option largely reflects current administrative practice of the Internal Revenue Service. We note that an exception for measures recommended by a veterinarian for the health of the animal is quite broad and could serve to eliminate much of the effect of the general rule in that even routine grooming is beneficial to the health of an animal. Thus, we would not object to a somewhat tighter formulation of this option.

"G. Apply UBIT to hotel facility income which is patronized by the public (with exception for facilities operated, but only to the extent necessary, in furtherance of the organization's exempt purpose). In addition, apply UBIT to retail sales of condominiums and time-sharing units."

We question the appropriateness of exempting from the UBIT any hotel facility income. Although the rental of dormitory rooms to students is appropriately exempt from tax, it is difficult to see how the rental of hotel rooms, per se, ever would directly further a tax-exempt purpose. Although an argument can be made that a school offering a degree in hotel management needs to allow its students to operate a hotel, a similar argument could be made for the operation of any commercial facility. If a hospital or a university desires to offer a subsidized rate for families of patients or students that are unable to afford commercial hotels, such activity may be appropriately exempt from tax as a service to low-income persons, but it would usually not be exempt as either a health-care or educational activity.

The application of the UBIT to retail sales of condominiums and time-sharing units reflects the current administrative position of the Service. We have no objection to codifying this rule so long as no inference is created with respect to the relatedness of other retail sales, which in many instances will similarly be subject to tax.

"H. Apply UBIT to routine testing income (with exceptions for Federal or State mandated activity, pre-surgical medical testing, and laboratory testing which is part of a student educational training program)."

Current Treasury regulations specify that routine testing does not qualify for the research exception to the definition of an unrelated trade or business. This discussion option does not similarly modify the research exception, but would affirmatively tax all routine testing. We believe that many organizations appropriately conduct testing as an integral part of their exempt function and should not be subject to such a rule. Thus, we suggest that this option either be directed at the definition of research or that exceptions be created for organizations whose principal exempt purpose includes testing. In addition, we recommend that if this option is adopted, the broad exception for "Federal or State mandated activity" be limited. States would have a strong incentive to "mandate," and therefore exempt from tax, many activities conducted by exempt organizations, particularly universities. Thus, the exception could to some extent swallow the rule. Also, we have a concern, similar to that noted earlier with respect to hotel facility income, that providing an exception for laboratory testing which is part of a training program may be unduly broad.

"I. Apply UBIT to income from affinity credit card/catalog endorsements."

To the extent income from credit card or catalog endorsements represents the rental of an exempt organization's mailing list, we believe it is already taxable under present law. If such activity reflects other motivations, the proper resolution is perhaps less clear. If the activity represents the exploitation of an exempt organization's goodwill for commercial purposes, we believe it should be subject to tax. If, however, the activity is more properly viewed as a means of fostering identification by members with the organization and of facilitating contributions, and the activity is limited to the accomplishment of those goals, it may be appropriate to exempt from tax the amounts received by the exempt organization that exceed the fair rental value of its mailing list. We believe further analysis of this relatively new practice may be required in order to determine which characterization is most accurate.

"J. Apply UBIT to advertising income and allow deductions from UBIT only for direct advertising costs."

Under current Treasury regulations, organizations that sell advertising in an exempt journal are not permitted to use the costs of producing the editorial portion of the journal to create a net operating loss from the sale of advertising. Thus, a college alumni magazine, for example, may allocate the cost of producing the articles in the magazine against advertising income, but not to the extent such an allocation would produce a net operating loss that could be offset against the income from other unrelated businesses.

The discussion option would permit advertising income to be offset only by "direct" advertising costs. Such costs would presumably include administrative expenses of selling and designing advertisements as well as a pro-rata portion of the production and distribution expenses of the magazine, determined by reference to the percentage of space in the magazine taken up by advertising. Disallowed costs would include those incurred for the "readership" portion of the magazine -- e.g., the costs of producing the articles and other features.

This option reflects the view that the production of advertising income is of only secondary importance to the production of a tax-exempt journal. As such, only direct costs of producing the advertising income are properly allocated to it. We recognize that such an allocation rule treats tax exempt journals differently, and less favorably, than taxable journals with respect to the computation of taxable advertising income. Nonetheless, we believe tax-exempt journals are in fact fundamentally different from taxable journals and that Congress could appropriately adopt such a rule as one of the conditions of a journal enjoying the substantial benefits of tax exemption.

"K. Apply UBIT to theme/amusement parks."

We consider this option to be a codification of present law. While amusement parks may have some educational value, we believe the educational component is secondary to the purely recreational component. Consequently, the activity is not substantially related to an exempt function and the income is appropriately taxed. Hence, we have no objection to a codification of this rule.

"L. Apply UBIT to additional specified activities determined to be inherently commercial."

Taxing all activities that are inherently commercial would be a significant departure from current law and could create widespread confusion as to who is affected by the rule. Many tax-exempt organizations -- particularly hospitals and universities -- are "commercial" in that the great majority of their income is derived from the sale of services to the general public.7/ Thus the adoption of a "commerciality" standard would presumably require Congress to create a number of exceptions to the rule for traditional exempt activities. Although such an approach would be possible, we believe the better approach at this time is for Congress to identify the particular activities that it considers not to merit tax exemption, as it did for the sale of commercial insurance products in the Tax Reform Act of 1986, and as options A-K do.

7/ Overall, approximately 38 percent of non-profit revenue comes from fees, charges, and dues. Hodgkinson and Weitzman, Dimensions of the Independent Sector (Wash. D.C., 1986), p.32. Data are for 1984.

II. Convenience Exception:

"Repeal "convenience" exception (income from activities carried on primarily for the convenience of a Section 501(c)(3) organization's members, students, patients, officers, or employees). Income from activities that are substantially related to the organization's exempt purpose would remain tax free, subject to the specific rules listed in Section I. above."

In my June testimony, I suggested that the scope of the convenience exception should be reexamined. We would support this option because we are concerned that the exception in its present form may extend to activities not meriting tax exemption and is not justified by administrative considerations. The convenience exception has had the effect of significantly broadening the range of activities exempt from the UBIT and has freed exempt organizations from the responsibility for deciding whether particular activities are in fact substantially related to the exempt function of the organization. Subjecting income from these activities to tax would not, of course, prohibit them from being undertaken. To the extent they are truly carried on for the convenience of members, it is unlikely that much, if any, tax liability would be incurred. In order to ease the administrative burden on exempt organizations of repealing the convenience exception, we would suggest creating some clearly defined safe harbors -- such as providing services at cost -- that would obviate the need for detailed tax accounting.

III. "Regularly Carried On" Test:

"Repeal "regularly carried on" test. Income from an activity that is not a trade or business would remain tax-free."

Under current law, the UBIT applies only to income from an unrelated trade or business regularly carried on by an exempt organization. The UBIT regulations provide that even an activity taking place only once a year can be "regularly carried on" and thus subject to the UBIT if taxable businesses are carried on with similar infrequency. This option would affect activities that are typically carried on by taxable businesses on a year-around basis but, for whatever reason, are carried on by tax-exempt organizations only periodically. For example, an exempt organization under present law could conduct a once-a-year furniture sale and presumably not be subject to the UBIT. This option would cause such an event to be taxable provided that other exceptions to the UBIT, such as those for donated property or businesses operated by volunteers, did not apply. Although we do not oppose the option, we suggest that it be modified so as not to apply to periodic fund-raising events where no clear commercial analogue exists.

IV. Tax Treatment of Royalty Income:

"Apply UBIT to royalties measured by net or taxable income derived from the property; or royalties received by an organization for use of property if such organization, or closely related organization, either: (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property. Retain present law for certain non-working property interests, and exception for products that are part of the organization's exempt function."

Royalties are excluded from the calculation of the UBIT along with dividends, interest, annuities, and rents. As we noted in our June testimony, the legislative history of the enactment of the UBIT in 1950 suggests that Congress created these exceptions because such investments were passive in nature and unlikely to create competitive problems. If such Congressional intent remains valid today, we believe some change in the applicable law is desirable.

Although neither the statute nor the regulations define the term "royalties" for purposes of the passive income exception, virtually any payment for the right to use intangible property could be characterized as a royalty for tax purposes. Thus, it may be possible for a variety of fees to be called "royalties" and be treated as exempt from tax even if they do not in fact represent passive income. Hence, we believe there is a need for Congress to specify what the term "royalties" means for purposes of this exception.

The option would affirmatively subject certain kinds of royalties to the UBIT. We believe it would be undesirable, however, for Congress to tax all royalties not meeting certain requirements; in some cases such royalties represent exempt function income and should not be taxed. We suggest instead that Congress simply delineate the bounds of the royalty exception to the UBIT. As so modified, this option would provide that royalties measured by net or taxable income, or royalties received for use of property created by the organization, not be eligible for the royalty exception to the UBIT. Other sections of the Internal Revenue Code distinguish between active and passive royalties in a similar fashion. In the case of both domestic and foreign personal holding companies, for example, certain passive income can trigger additional tax and thus taxpayers wish to avoid the characterization of royalties as passive income. In response to such concerns, sections 543 and 954 exclude from the definition of the term "royalties" those royalties derived from the active conduct of certain trades or businesses. Similarly, the passive loss provisions of section 469 distinguish royalties derived in the ordinary course of a trade or business from other royalties.

Royalties considered active under this test would not necessarily be subject to the UBIT. Such a royalty would not be taxable if it constituted exempt function income or satisfied another exception to the UBIT. For example, a university performing contract research and receiving a royalty as part of its compensation would not be subject to tax on the royalty so long as the requirements of the research exception were satisfied.

V. Deduction from Taxable UBIT:

> "Increase $1,000 UBIT deduction for certain Section 501(c) organizations to $5,000 or $10,000, with phase-out beyond $50,000 income level. Limit the increased deduction to activities directly carried on by the exempt organization."

As we stated in our June testimony, we recommend that the $1,000 UBIT deduction for certain section 501(c) organizations be raised to $5,000 to adjust for inflation. We also have no objection to a $10,000 figure, with a phase-out, as part of a package of reforms to the UBIT. An increase to $10,000 would simplify the system for many small organizations with relatively small amounts of unrelated income. We would not object if the increased deduction were limited to income from activities directly carried on by the exempt organization rather than, for example, income from a limited partnership interest. We would also have no objection to Congress' distinguishing between section 501(c)(3) organizations and other exempt organizations in setting the amount of the specific deduction.

VI. Unrelated Debt-Financed Income:

> "Limit the current law UBIT exception for unrelated debt-financed property to only those pension funds, educational institutions and title holding companies that make at least a 20 percent equity investment of their interest in the property. Retain character of debt-financed income received from all pass-through entities."

While we understand concerns about tax-exempt organizations engaging in leveraged real estate investments, this option adds another level of complexity to an area that is already tightly constrained. The first rule would be difficult to administer in the case of joint ventures involving numerous activities. We believe the present rules of section 514 are adequate to deal with the kinds of abusive transactions that prompted the enactment and amendment of the section. Absent a showing that exempt organizations are in fact engaging in highly leveraged real estate transactions for tax-motivated reasons, we hesitate to endorse this proposal at this time.

The part of the option pertaining to pass-through entities may affect the character of income earned by tax-exempt holders of interests in regulated investment companies ("RICs"), real estate mortgage investment conduits ("REMICs"), and real estate investment trusts ("REITs"). Such a provision would represent a significant change in the treatment of such entities. It would also impose complicated record-keeping and other administrative burdens. If the intent of the option is to prevent tax-exempt organizations from avoiding the restrictions of section 514 by investing through these entities, we suggest that any such rule be limited to avoidance situations. For example, the rule could be applied only to those cases in which a REIT is highly leveraged or is owned substantially by exempt organizations.

VII. Subsidiaries and Joint Ventures:

"Modify the definition of "control" in the case of exempt organizations having taxable subsidiaries. Define "control" as ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value (rather than 80 percent of combined voting stock, under present law)."

Modifying the definition of control from 80 percent to 50 percent is consistent with our June testimony.

"Extend "control" rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock."

We view this option as a reasonable corollary to lowering the definition of control from 80 percent to 50 percent.

"Provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization."

We understand that this rule is intended to prevent an exempt organization from dropping a profitable unrelated business, together with a money-losing related business, into a taxable subsidiary. The loss from the related activity would thus offset the profit from the unrelated activity. If both businesses were carried on by the exempt organization, no such offset would be allowed. Although we are not aware that this kind of tax avoidance is in fact being practiced, the enactment of the option might prevent such schemes in the future. Thus, we do not see a pressing need for the current enactment of this option, but we have no objection to it on conceptual grounds. If the option is enacted, we believe it would be appropriate to clarify that certain payments, such as rents, royalties, and interest, to the parent organization would remain deductible.

"Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of parent is a tax-exempt purpose."

As we stated in our June testimony, aggregating controlled subsidiaries when determining whether the primary purpose of the parent is tax-exempt would be a useful tool in helping to ensure that unrelated business activities do not supplant an organization's exempt function. Among the factors that should be considered in determining an organization's primary purpose are its expenditures for charitable and unrelated business purposes, income from different activities, reasonable expectations of earning a profit, and staff time spent on different activities.

VIII. Allocation Rules:

> "With respect to facilities used for exempt purposes as well as unrelated business purposes, allow a deduction against UBI for a proportionate share of the direct operating cost of the facility (e.g., maintenance, insurance, and utilities), but not allow a deduction for a share of the general overhead of the organization or for depreciation."

In my June testimony, I recommended that Congress clarify the appropriate allocation of shared expenses between exempt and unrelated activities. In particular, I stated that the allocation method endorsed by the Court of Appeals for the Second Circuit in Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1984), failed to properly distinguish between an organization's related and exempt activities. We continue to believe that the decision in Rensselaer results in an inappropriate allocation of expenses and that the appropriate rule would be to allocate fixed costs based on hours of use in the unrelated business compared to the total time available for use.

We have certain reservations about this discussion option, which differs from the recommendation made in my June testimony. We believe that some depreciation and some portion of general overhead may, in certain cases, be appropriately allocated to the unrelated business. For example, if a college president in fact spends five percent of his time attending to an unrelated business, it would generally be appropriate to allocate five percent of his salary to the activity.

Notwithstanding these reservations, we would prefer either the discussion option or an allocation method based on total available time to the uncertain state of current law. We would welcome legislative clarification in this area because it has proven extremely difficult for the IRS to administer and there exists evidence of liberal, and in some cases possibly abusive, allocations. The discussion option, like our June recommendation, would limit the extent to which taxable income from unrelated businesses can be reduced by means of allocating shared costs that were incurred principally for exempt purposes. Both approaches recognize that cost allocation principles applicable to two activities of a taxable business should not necessarily govern the allocation of costs between related and unrelated activities of an exempt organization.

Exempt organizations are granted substantial governmental subsidies not so they may engage in unrelated businesses, but so they may carry out their exempt purpose most effectively. To allow deductions for depreciation and overhead based on the formula approved by the court in Rensselaer suggests that the various forms of governmental subsidy were intended to benefit equally the exempt and unrelated activities. They were not.

IX. Tax Information Reporting/Internal Revenue Service (IRS) Administration:

> "Expand Form 990-T reporting requirement to include more reporting on: (1) activities and income which the organization claims to be exempt or excluded from UBIT, and (2) revenue sources such as contributions, grants or other funding sources."
>
> "Provide more detailed reporting of revenue-producing activities and income on Form 990."
>
> "Consider "short form" reporting for small organizations, based on revenues."

We believe that options regarding improved data collection are very important to the long-term effort to analyze the UBIT and tax exemption in general. In fact, we are already working closely with the Internal Revenue Service to improve Forms 990 and 990-T so that we will be able to collect relevant data for analyzing the activities and trends in the exempt organization area. We believe that a Congressional affirmation of these steps would be appropriate.

> "Require affiliated group that includes an exempt organization to file a consolidated information return."

> "Recommend that IRS have an integrated examination program for exempt organizations and subsidiaries (taxable and exempt)."

We believe both these recommendations are sound. The Internal Revenue Service already has under review the possibility of an integrated examination program, which we believe would increase the efficiency of exempt organization audits. In addition, consolidated reporting should substantially increase the ability of the Service to accurately understand the business activities of affiliated groups of organizations in which some organizations are taxable and some are exempt.

> "Recommend that IRS conduct the following studies and report on: (1) nonprofit exempt hospital reorganizations (examining the extent, purpose, effect of the use of subsidiaries); (2) exempt organizations that file Form 990s but do not file Form 990-T's (examining activities of a sample group to determine compliance with UBIT); (3) the feasibility of requiring State and Federal land-grant universities to file an information return; (4) the use, purpose and effect of joint ventures; and, (5) study, after five years, on effect of UBIT changes."

We have no objection to Congress mandating these studies, which we believe would be valuable resources if Congress intends to revisit this area of the law within the next five to ten years. We would hope that similar analyses, based on improved data collection on the part of the Service, would be undertaken by private groups as well.

X. Miscellaneous:

> "Codify IRS position (upheld by some courts) that a social club (or other organization whose investment income is subject to UBIT) may not, in determining UBIT, reduce its net investment income by losses on sales to non-members."

The issue presented by this option is similar to that presented by the allocation rules, discussed above. We believe it is inappropriate for social clubs to be able to offset taxable investment income with losses from the use of their facilities in transactions with non-members. In 1969 Congress affirmatively acted to subject such investment income to tax. To permit a social club to avoid such tax by deducting expenses that, for the most part, would be incurred in any event as part of its exempt function seems inconsistent with the intent of Congress.

We would emphasize, however, that we have no objection to a social club engaged in unrelated business activities with non-members being permitted to carry any losses forward or back to offset income from such activities. Hence, we believe the scope of this option is appropriately limited to offsets against investment income.

> "Exempt from UBIT an organization's contingent rental income received through a prime tenant, where the prime tenant leases real estate from a tax-exempt organization, the prime tenant's net profits are based on fixed rents derived from subtenants, and the prime tenant does not provide services to subtenants except through an independent contractor."

This option is similar to a rule that already applies to real estate investment trusts ("REITs") which, like exempt organizations, are entitled to favorable treatment for rental income only if certain requirements are met. Among these requirements are that the rent received by the REIT or the exempt organization not be based on the net income or profits of the tenant. Under current law, REITs are allowed to utilize a "prime tenant" to serve, in effect, as a conduit for the rental of real estate, and to receive a percentage of such prime tenant's net income as rent, so long as the prime tenant itself satisfies the rules applicable to the REIT. This option would permit exempt organizations to make similar use of a prime tenant.

Although we do not object strongly to this option, we are uncertain as to the pressing need to liberalize the UBIT in this manner. Hence we propose further analysis of this option, in order to consider how its enactment would further the exempt purpose of organizations that would utilize the option.

"Exempt from UBIT investment income earned from non-refundable loan commitment fees."

This option, like the preceding one, is based on the current REIT rules. REITs must receive most of their income from passive real estate related investments. Passive real estate income permitted a REIT includes amounts received or accrued as consideration for entering into agreements to make loans or to purchase or lease real property. Thus, under this REIT provision, it is not necessary that a loan in fact be made for the income from the commitment fee to be considered passive. Under current UBIT rules, in contrast, loan commitment fees are not explicitly excluded from the UBIT. We are uncertain as to the need to liberalize the UBIT rules in this area. We note that REIT rules and the UBIT rules are not identical and in fact have quite different policy justifications. REITs exist for the primary purpose of making real estate related investments, and the applicable rules are designed to encourage such purpose. Exempt organizations, of course, must have a different primary purpose.

"Modify rules applicable to organizations "testing for the public safety.""

Congress adopted the "testing for public safety" exception in 1954 after one organization doing such work had its exemption as a scientific organization under section 501(c)(3) revoked. The rationale for this exemption was not explained in the legislative history and is not entirely clear. The treatment of such organizations is different from that of other section 501(c)(3) organizations. They are expressly exempted from classification as private foundations, and contributions, bequests, or gifts to them are not deductible. Since the income of such organizations is not dedicated to traditional charitable purposes, it may be appropriate for Congress to consider taxing their investment income for the same reasons I suggested last June with respect to social welfare organizations described in section 501(c)(4). Congress may also wish to consider studying the exemption granted these organizations in order to determine whether it continues to be appropriate in its present form.

"Consider modification of various piecemeal UBIT exclusions enacted since 1969."

Because this option does not specify which piecemeal exclusions are being considered, it is difficult for us to comment here with any specificity. As a general matter, however, we oppose such special exclusions from the UBIT because they create inequities between different exempt organizations and have the potential for creating unfair competition. Nonetheless, just as Congress may now find it appropriate to indicate that certain specific activities are subject to the UBIT, we realize that in some cases it is appropriate to indicate that certain specific activities are exempt from the tax. Should the Committee desire to modify any of these special exclusions, we would be happy to work with you.

XI. Options not Listed

A. Research

We stated in our June testimony with respect to the "research" exception from the UBIT that we believe additional attention should be given to the definition of research. Support of research is a national policy that reflects the critical importance of fundamental research to our economy and future. Although we are unaware of significant abuses in the area of research, we continue to believe some clarification is appropriate in this area. The UBIT statute, regulations and case law fail to define precisely the term "research," and without such a definition the full benefit, or limitations, of the exemption may not be understood or realized. The scope of the term "research" has been delineated for purposes of other Code sections, such as section 41, the credit for increasing research activities, and section 174, permitting expensing of certain research and experimental expenditures. These provisions, like the UBIT exception, are intended to provide an incentive for research. Thus, we believe that carefully considering the definition of research developed in these other contexts may prove useful in order to develop a definition of research for purposes of the UBIT.

B. Charitable Contributions

The most significant income-producing activity of many tax-exempt organizations is the solicitation of contributions from members and the public at large. Although such solicitations generally do not constitute a trade or business because they do not involve the sale of goods or services, we have some concern about charitable solicitations that effectively involve a sale or exchange of an item of value. Our concern, however, is not so much with the taxation of the exempt organization, but with the availability of the charitable deduction to donors.

Under present law, contributions to certain charitable, educational, scientific, and other organizations are deductible from the donor's income. If an item of value is received in exchange for a charitable contribution, however, a deduction is allowed only to the extent the amount of the contribution exceeds the fair market value of the item. We believe this limitation on the amount of the allowable charitable deduction is often ignored by taxpayers, sometimes with the implicit encouragement of the charitable donee. Thus, an exempt museum will charge admission or a school will sell raffle tickets, but the payments will be described as a "contribution." Similarly, exempt organizations will conduct fundraising drives in which increasingly large contributions entitle the donee to receive increasingly more valuable articles of merchandise in return.

This present state of affairs concerns us for two reasons. First, there is a revenue loss to the government when donors fail to reduce the amount of their charitable deduction by the value of goods or services received. Second, and perhaps more importantly, such overstated deductions create disrespect for the tax system because of the perception that "everyone does it."

Congress acted in 1987 to require that exempt organizations not entitled to receive deductible charitable contributions must disclose that fact on fundraising solicitations. We believe that Congress should consider enacting a similar rule for organizations entitled to receive charitable contributions that supply goods or services as a specific quid pro quo for a contribution to the organization. Under such a rule, the exempt organization would be required to inform donors that the deductible amount of any contribution is limited to the difference between the amount of the contribution and the value of the property or services received. The organization would be required to place a reasonable value on such goods or services for this purpose. An alternative, or complementary, approach to this same issue would be to require that non-deductible payments, such as school tuition, to an exempt organization be paid to a designated account, the name of which would indicate its non-charitable purpose.

Conclusion

The discussion options and this hearing represent important contributions to the goal of developing legislation to update and reform the UBIT. As I have noted, it would be premature to make far-reaching changes to the law at this time. Nonetheless, some of the discussion options discussed above are quite specific and we support a number of them. Also, the discussion options proposing increased data collection and the completion of certain studies will enable Congress in the near future to address more fundamental questions about the appropriate scope of tax exemption as well as the structure of the UBIT. Finally, I would like to emphasize that my evaluation of the discussion options has treated each option as a separate, independent proposal. When the proposals are incorporated into a legislative package, it will be important to assess the overall administrative impact of such legislation on tax-exempt organizations in order to determine whether the benefits of the legislation justify the imposition such burdens.

This concludes my prepared remarks. I would be pleased to respond to your questions.

Chairman PICKLE. Thank you, Mr. Secretary.

Now, Mr. Secretary, in the interest of time, I am going to ask a lot of questions because I think your testimony goes into detail in many respects on the various questions we have raised on the questions concerning discussion options. I thank you for this testimony.

I want to get your general attitude, however, as to our approach. You contend that we must be careful not to make changes or to keep questions on the books that would cause administrative difficulties. You referred to the fact a lot of these changes might be a burden to the Treasury. It is a burden now, as I understand it, in many respects, and while we might want more information, are you recommending we hold up consideration on this while we look at this so-called taxpayers' compliance measurement program, the TCMP?

Mr. CHAPOTON. No, Mr. Chairman. We are not making that recommendation. We are simply saying in the options, the carefully constructed options you have proposed, we are very supportive of those, and we do not think that the implementation of those should be delayed. We have some reservations about various ones of them, and we have stated those reservations in the testimony.

But we don't have any broad reservation about the matters as a whole. Where we have administrative reservations, we have stated them as well.

Chairman PICKLE. But you are recommending then we do proceed and try to move forward with some modifications and suggestions you have given us. In general, it would seem to me that you have endorsed, with some reservations, most of the options that we have proposed or had advanced.

Mr. CHAPOTON. That is correct.

Chairman PICKLE. I think that is helpful, and we are glad to know your position on it.

Now, as we proceed, though, with this process we will be working closely with you and the IRS to find better ways to implement these general recommendations and/or modifications you made. So I thank you very much for your testimony.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I will try to follow the same ground rules, because time will be a problem today, and we want everyone to have the opportunity. I am only going to pursue one line of questioning, and that is in regard to substantially related. In your testimony you say, "We share the concern that the related standard has been applied in an overly generous manner." That is on page 7 and on page 8, I won't read the whole thing, but you say that the present standard for relatedness may in operation permit activities to be treated as exempt even though their connection to the original exempt purpose is quite tenuous. Substantially related should be a fairly high standard. It is similar to the material participation test, which applies to tax shelter activities. In fact, sometimes the term "substantial" probably is an even more demanding standard than material. Treasury and the IRS have pursued the interpretation of the term "material participation" with a pit bull type attitude, but they interpret the "substantially related" more like a pussy cat or a kitten might. That point is at the heart of why we are here. If the

Treasury and IRS had been a little more aggressive, we might not have to be here today.

I am wondering why the Treasury is so tough in applying one term and so relatively weak in applying the other.

Mr. CHAPOTON. Mr. Schulze, I understand your concern about that, and certainly the material participation standard in the passive loss rules is something we have devoted quite a lot of time to and tried to spell out very clearly.

I might say one reason we have tried to be very precise in that area is because so many commercial activities are going to turn on how we define material participation in the passive loss rules. We felt it absolutely essential that we make that rule clear so as to not inhibit commercial activities. We feel a significant responsibility in allowing certainty for taxpayers to go forward in making investments and engaging in businesses.

I guess I would have to agree that the same fervor should be devoted to the substantially related test. It is a somewhat nebulous concept, more nebulous, I think, than material participation perhaps, but I can see the argument that further attention could make it more precise. I can simply say——

Mr. SCHULZE. We are talking about a $300 billion sector of our economy. I don't know what tax shelters amount to. Maybe it is even more, but it seems it is a fairly important part of our economy and one that could benefit from that same kind of vigor and enthusiasm.

Mr. CHAPOTON. It is important, Mr. Schulze, but while I agree with you that it is a large sector of the economy, it is not a revenue producing matter. Even were we to define the test much more stringently, it is not likely it would produce a great deal of income.

Mr. SCHULZE. I have to agree, but I don't know whether we should apply that standard to everything we do. We really should look at clearly defining these lines so that people know where they are going whether they are exempt or nontax exempt. We probably should pursue them with the same vigor.

I come back to my thought that had this been done, these hearings and all of this effort might not be necessary. So if you have any thoughts on how it should be done in the future, we would be happy to have your thoughts.

Chairman PICKLE. Thank you, Mr. Schulze.

Mr. Rangel, do you have any questions?

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Chapoton, early on in the Reagan administration, great emphasis was given to charitable, nonprofit, volunteer organizations filling the gaps that existed as a result of the dramatic cutbacks in domestic spending. Are you familiar with that policy?

Mr. CHAPOTON. Well, I am familiar with the tax—you mean the nontax cutbacks in spending?

Mr. RANGEL. Yes, the cutback in domestic spending, the budgetary cutbacks. The President often said the poor would be taken care of in terms of the safety net because he expected volunteers, nonprofits and charitable organizations, to come in and vigorously and traditionally protect these people. You are familiar with that philosophy?

Mr. CHAPOTON. I am extremely familiar with the spending cuts and things of that nature, yes, sir.

Mr. RANGEL. But are you familiar with the administration's position that he expected these tax-exempts to fill the gap and protect these people?

Mr. CHAPOTON. Well, I think it wasn't just the tax-exempts as such that was referenced to. It was just charitable giving in general.

Mr. RANGEL. Exactly. Exactly.

Now, do you know whether or not there was any shifts in the opinion as to the flexibility in allowing these organizations to secure additional income so that they would be able to carry out this mission?

Mr. CHAPOTON. Well, I do not think there has been any shift with respect to obtaining additional income from commercial activities.

Mr. RANGEL. So that while there was an additional burden put on these organizations, you don't know of any administration policies to make it possible for them to receive additional income in order to carry out that policy?

Mr. CHAPOTON. No, Mr. Rangel. I think there were no specific ideas. I think the concept was Americans would fill the need by charitable giving, but they did not need to be encouraged to do so by tax measures of the sort we are talking about here, particularly commercial activities by tax-exempts.

Mr. RANGEL. Would you agree that under recent reform in the tax system incentives for giving have been reduced dramatically?

Mr. CHAPOTON. I would agree that that has certainly been the effect. Any time you lower the tax rates, charitable giving is not as valuable from a tax standpoint. However, the data shows that charitable giving on the whole has not dropped as a result of that. Now I am not sure how precise that data is yet.

Mr. RANGEL. So you don't see any need to change the policies based on the increased responsibilities to the charitable organizations?

Mr. CHAPOTON. Well, I have just been handed a note here that actually since 1986, since the 1986 act, which would have had the obvious adverse effect that you have pointed out, there has been an increase in charitable giving; so for whatever reason, there has been a positive effect on charitable giving. We can't claim the tax law caused that, because the tax law went in the other direction. But I think the point is it is our hope that the tax law is not the motivating factor in charitable giving in the first place; and, therefore, these changes we are proposing are appropriate to create the system, make the system fair and just and that in itself ought to have a positive effect, or at least not a negative effect.

Mr. RANGEL. Well, you do agree that it is——

Mr. MCGRATH. Would my colleague from New York yield?

Mr. RANGEL. I don't want to lose this point. It is the administration's position, as all administrations, however, that wherever possible we should provide incentives for giving, that is, that you don't have any problem with the Tax Code being a vehicle for social change as well as for raising revenues, do you?

Mr. CHAPOTON. Well, I think that there needs to be a recognition, there has long been a recognition of the need to exempt charitable organizations from tax and to allow charitable contributions, reasonable charitable contributions. I think that the extent to which the Tax Code is used to effect social change needs to be carefully studied. I think the 1986 act, at least in using the Tax Code to encourage various business activities, was certainly limited.

Mr. RANGEL. I am not talking about that. I am talking about public policy in terms of charitable giving and continued volunteer services. There is no question that that is a part of our national tradition and should be incorporated in any tax policy.

Mr. CHAPOTON. I would agree with that statement, Mr. Rangel, so long as it is done reasonably, and I think what we are talking about today is where in the UBIT area is considering whether it has gotten out of hand.

Mr. RANGEL. Exactly. But there have been no recommendations at all from the administration as to how to increase giving as relates to what the President would call increased responsibility?

Mr. CHAPOTON. No. We have no recommendations of that sort.

Mr. RANGEL. I yield.

Mr. MCGRATH. I just want my friend from New York to be able to delineate to some extent between those tax-exempt organizations which perform the necessary safety net operations as opposed to the myriad, thousands of others which do not.

Mr. RANGEL. I would agree. But as the chairman pointed out, it seems as though it has been under his leadership that we have asked the administration for their responses to our legislative options. Would you agree, Mr. Chapoton, that the failure of the administration to look into the fairness and unfairness of our tax policy with charitable organizations have been political rather than sound tax policy?

Mr. CHAPOTON. No, Mr. Rangel, I don't think I would agree with that. I think it has not been political at all. With volunteer organizations, like all others, you get into this murky area where the commercial activity is related and it is a murky area. It does need thorough study and review, and I suppose I would plead guilty to not causing that review to be studied by Treasury before it was raised first by the chairman. But we have certainly welcomed this study. We have had ongoing study, ongoing work on it from time to time, but all-encompassing and broader study and the man hours that have been devoted to it since this committee raised the issue have been very worthwhile.

Mr. RANGEL. You have responded courageously. I just don't recall Treasury or IRS saying it was murky, there was fraud or abuse, and this committee should look into it, but at least we are reaching the same objective.

Thank you, Mr. Chairman.

Chairman PICKLE. Now Mr. McGrath.

Mr. MCGRATH. I have no questions.

Chairman PICKLE. Well, I think Mr. Chapoton—let me ask a couple of questions. One, a number of the tax-exempt organizations have commented to our committee that several key discussion option positions would treat tax-exempt organizations worse than the for-profit organizations, particularly in such areas as advertising income, allocation and aggregation of activities for purposes of determining the organization's tax exemption. How would you respond to that observation that the tax-exempt organizations are making?

Mr. CHAPOTON. We understand that point, that allocation rules would treat tax-exempt entities less favorably from the allocation standpoint than commercial enterprises. But we, frankly, think there is some justification for that because where a tax-exempt organization is formed and operated for a tax-exempt purpose, it is quite reasonable to consider the commercial activity it engages in as a marginal activity and that it should be able to allocate to that marginal activity only the expenses related to that marginal activity, not expenses which it would have incurred anyway in engaging in its tax-exempt pursuits.

The case of the field house that I referred to earlier is an example of that. Another case is in a book publication or a magazine publication. If the magazine is to be published for a charitable purpose, it would have editorial comment and discussion whether or not it had advertising and it would incur that expense whether or not it had advertising. That is a tax-exempt function. Now if it has advertising—and it would earn some income from sales of a magazine and whatever, but if it has advertising income, that is a commercial purpose, and we think that only the marginal costs related to earning that advertising income should be offset.

Chairman PICKLE. Now, Mr. Secretary, this is one of the constant statements we hear over and over again. This is a rather broad question, but I want your comment on it. A lot of the tax-exempt organizations tell us that unrelated income should not be taxed because the money that comes in from whatever they are doing goes back into the organization, whether it is unrelated or directly related to their tax-exempt purpose. How do you respond to that? There seems to be a common claim by every organization that is out here today, that no matter what they are doing, the money goes back into the organization and shouldn't be taxed. Do you agree with that?

Mr. CHAPOTON. No, Mr. Chairman. I think that is far too broad. The mere fact that the money is devoted to a charitable purpose does not, in our view, justify the organization entering into a commercial activity. To have a rule that would say otherwise would encourage tax-exempt organizations to engage in commercial activities. It would, in effect, allow them to perform commercial activities with a greatly reduced tax cost and would, therefore, encourage these activities so long as they could be profit making.

It has the unfair competition aspects that we referred to, which are hard to pin down, but we think there is undoubtedly some aspect of that that is very realistic, that there is unfair competition or could be unfair competition by a tax-exempt entity. It involves the question of just plain efficiency, whether the tax exemption given to a tax-exempt entity, if it goes to encourage a commercial activity, is an efficient way for the U.S. Government to give a Federal subsidy. We think it is probably not an efficient way to give a subsidy, and, finally, if it is carried to its extreme, it allows the organization to engage in commercial activities generally and have only an incidental tax-exempt activity and, therefore, from a fairness standpoint, we don't think there is much support for that rule generally. The question is how it is applied in the closer cases where there is some relation to the tax-exempt activity and where the commercial activity is only small in relation to the noncommercial activity.

Chairman PICKLE. Mr. McGrath I believe wants to ask a question.

Mr. MCGRATH. Mr. Chairman, if I might, I believe the Secretary has hit the nail on the head. In some cases, we are trying not to encourage some of these 501(c)(3)'s from getting into commercial activities. Yet when we get to situations like aggregation and allocation and some of these other things, your own statement and testimony say we are getting into murky areas where they are somewhat ill defined.

What about taking a different track. Say by defining to the extent we can, what is allowable and what is not, and then making the penalties so grave that if some of these activities that are deemed to be unallowable are engaged in by these organizations, that they would be penalized severely? Wouldn't that be more of a deterrent than trying to come up with fixed definitions for every activity of these organizations?

Mr. CHAPOTON. Well, I think even then, as I understand what you are suggesting, wouldn't you have to have definitions to determine when the penalties would apply?

Mr. MCGRATH. Some, yes.

Mr. CHAPOTON. I think there is line-drawing no matter where you have it. Even in the aggregation area, we were not announcing any new concept there. If a tax-exempt entity that does not have subsidiaries engages directly in unrelated business commercial activities, you aggregate those and that very clearly determines whether its principal purpose is tax-exempt or commercial. It is only when, under current law, if it drops the activities into a controlled subsidiary, you do not aggregate. We are just proposing aggregation be considered a little broader.

It is very difficult to have line drawing. All the options we have talked about here today, they are close to the wire. If you violate those, you are subject to tax on the income. That is one penalty. If you go too far, you lose your entire tax exemption because the entire purpose is no longer tax-exempt, but is commercial. Those are pretty stringent penalties and seem to work.

The only question is the line drawing and the definitions.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Secretary, I would like to submit a couple of questions to you on the subject of the treatment of master limited partnership income by tax exempts. I won't take the time to go through them now, but I would like to submit them to you for answer.

Let me ask you a question generally about your testimony. As I understand your testimony, it seems you are saying that there are many recommendations here that are necessary and advisable. But you think substantially more information is necessary for us to determine what kind of far-reaching, long-term changes we might want to make.

That is how I read this testimony. Is that a fair characterization of what you have said?

Mr. CHAPOTON. Yes, sir. Generally, we think in view of the complexity and the far-reaching nature of the tax-exempt world, we need to go very slowly. We think that the options being considered represent a measured response to the areas in which we have sufficient information. But there are a number of other areas which we do not have sufficient information, and they should be—the study of those should continue.

Mr. DORGAN. Let me ask you briefly about the issue of changing substantially related to directly related. What we are talking about here is drawing lines. Under the best of circumstances drawing these kinds of lines is very difficult. In most cases, it is not done legislatively, it is done administratively in rules and regulations. I don't think any of us quite understand the full menu of what would occur if we were to change substantially related to directly related.

Could you provide me and the other committee members with an analysis of what that change in terms would do if we change the law to accomplish that? What would it mean for a whole range of tax-exempt activities in the country?

Mr. CHAPOTON. Mr. Dorgan, I think we could attempt to do that, but I think our main concern about that proposed change is that it might not really be a substantive change, that the term "directly related" is so close to the current law, "substantially related", that it is not entirely clear that you would move the ball that much closer to the right spot. It would cause some confusion and uncertainty, and, therefore, we think, at least we have some practice, and there are areas where substantially related is well-delineated and well-defined and is working well.

In fact, there are a number of areas. I don't think we should act like these rules are not working well at all. They are. It is just the close questions where they are not working well, and we wonder if putting in a new standard that doesn't add a great deal of clarity is justified.

Mr. DORGAN. I wonder exactly what would be accomplished or what would result if those terms were to be interchanged. You suggest one of the reasons you don't support it is that it would have no substantive consequence. Yet others oppose it precisely because it would have substantial consequences.

Mr. CHAPOTON. Well, I understand that, and I am not saying it wouldn't have some, but its effect, I think, would be marginal. But we could attempt what you are suggesting. We could try to write down some areas in which we think it would have an impact.

Mr. DORGAN. I would be interested if you would.

Let's assume we went ahead and changed the definition of directly related. What, in your judgment, is a consequence of that? Could you provide that to us as we consider these decisions?

[The following was subsequently received:]

The "substantially related" test is, at least in principle, a difficult one to meet. Under Treasury regulations, a trade or business has a substantial relationship to an organization's exempt purposes only if the conduct of the business activities has a substantial causal relationship (other than through the production of income) to the achievement of exempt purposes.

To meet this standard, the production or distribution of the goods or the performance of the services from which the income is derived must contribute importantly to the accomplishment of those exempt purposes. The regulations further provide that the performance of such activities is substantially related only to the extent that the activities are conducted on a scale reasonably necessary to accomplish the exempt purpose. Moreover, if an exempt organization exploits goodwill or other intangibles generated by an exempt function in commercial activities, the mere fact that the resulting income may depend in part upon an exempt function does not make the activity substantially related.

The application of these principles depends on the facts and circumstances of each case, and the Service has issued numerous private letter rulings and revenue rulings as to whether particular activities are substantially related to an organization's exempt purpose. Any organization that has relied on a ruling under the substantially related standard would be uncertain of its tax liability under a directly related standard. Thus, confusion would result even though in the vast majority of cases the result would likely be the same under the substantially related and directly related tests. It is possible that a change in the wording of the standard would result in certain activities being subject to the UBIT that are not subject to the UBIT under the substantially related test. It is likely, however, that many activities that would not be considered directly related would also not be considered substantially related under the present guidelines. Hence, there is no reason to believe that results would be more certain or consistent under a directly related standard.

Mr. DORGAN. As Congressman Schulze indicated, there are $300 billion in gross receipts from exempt activities. Clearly much of that would not be subject to UBIT under any circumstances. If there is, in fact, some tax gap in the UBIT area, what would changes in the law, similar to the type that are suggested here, accomplish? Can you give us any estimate of what that might be, what sort of gap are we talking about?

Mr. CHAPOTON. I think, Mr. Dorgan, it would be relatively small.

Mr. DORGAN. Is that——

Mr. CHAPOTON. I have some information on it here. The total income collected during 1986 was a total for unrelated business income, tax on unrelated business income——

Mr. DORGAN. It was $120 million, something like that?

Mr. CHAPOTON. Yes. It was $120 million, that is correct. It was $120 million in 1987, it was only $55 million in 1986, so it doubled in that 1 year. We don't have any real explanation of why it doubled. Perhaps the fact these hearings were held last year and focused attention on the UBI had some significant impact.

Mr. DORGAN. Enhanced voluntary compliance?

Mr. CHAPOTON. That is correct. But we could attempt to make some studies of what would be the impact if we had a much more stringent tax. But based on some analysis we have done about it—well, let me just approach it this way. Approximately 38 percent of all nonprofit sector revenue or about $96 billion came from dues, fees and charges in 1984.

Another 5 percent or $14 billion came from investment income. If all of this income was made subject to UBIT and there was no response by exempt organizations such as they are getting out of the business or changing the way they invested, then we could consider what tax from that would be.

The effective average tax rate on UBI is approximately 4.8 percent. If we applied this 4.8 percent rate to this total $109 billion in dues, fees and charges and investment income this is an increase in revenue over $5 billion.

While $5 billion is certainly a large figure, that is making a lot of assumptions which we know would not be true. That would be the maximum amount we would raise on that assumption.

Mr. DORGAN. Mr. Chapoton, thank you for your testimony.

As I go through your testimony, I think you have some good analyses of certain of these provisions. Many of us are concerned about what the result might be of small changes in the law. We appreciate your cooperation on working through those areas.

Chairman PICKLE. Mr. Secretary, we thank you for your testimony.

Mr. SCHULZE. Mr. Chapoton, perhaps in an effort to assuage some of the apprehension by others, let me ask you two very brief questions.

Some of the tax-exempt organizations are concerned that repeal of a regularly carried on provision may adversely affect their fundraising activities. How would the repeal of a regularly carried on provision affect most fundraising activities such as the charity ball, casino nights, carnival events, firemen or rotary clubs selling chicken along the roadside, and that kind of thing?

Mr. CHAPOTON. I am not sure about selling chicken along the roadside.

Chairman PICKLE. He should have said fillet mignon.

Mr. CHAPOTON. That begins to sound like a commercial activity.

Mr. SCHULZE. I believe you are aware that when you drive to the seashore in the summer, sometimes a fire company will sell a roasted chicken platter along the roadside.

Mr. CHAPOTON. As a practical matter, it would not have very much impact. Usually they don't produce any income, number one.

Number 2, it is usually activities engaged in by volunteers of the organization which is eligible for another UBIT exception. There are a number of these UBIT exceptions. Most of these rules we are talking about changing are trying to get at the abusive, borderline situations and would not impact the day-to-day operations——

Mr. SCHULZE. There has been some apprehension. That is the only reason I ask these questions.

The discussions options do not alter the voluntary labor exception. How would that voluntary labor exception interact with some of the discussion options. Would not the voluntary nature of most voluntary newspapers and radio stations continue to exempt their advertising income?

Mr. CHAPOTON. Absolutely. There would be many cases, just as we referred to before, many cases where the current volunteer exceptions would come into play and exempt that income.

Mr. SCHULZE. Thank you, Mr. Chapoton.

Chairman PICKLE. Once again, Mr. Secretary, I want to thank you. It is my feeling that Congress passed the Unrelated Business Income Tax. In the committee's discussion option we have not attempted to prohibit most of the practice going on now. We have not said you can't do this or you must stop doing that because I think we recognize that a great deal of the activity being carried on out in these tax exempt fields serves the public best.

We are saying if it is carried on, though, there will be a tax if it is unrelated. I think organizations must recognize that they just simply can't start a new activity or new business, no matter what it is, and pay no tax on it if it is unrelated.

I believe most organizations want to comply with that general approach. I am hoping that we will continue to have the cooperation of the organizations throughout the land.

We must recognize, though, that tax exempt organizations have grown in such an enormous amount. Today there are over 1 million of these organizations.

The revenue volume is potential. While we are not holding these hearings for the purpose of raising revenue, it is an item that would be considered just on the surface by the very nature of compliance.

Obviously that is so if we have found that in 1987, the income for tax evasion has gone from $55 to $120 million.

I believe the hearing has served a purpose. The organizations have taken notice of this. And I believe that they will want to comply with what we think is the law.

I am pleased that your recommendation in general support what committee offices have advanced. Though we recognize you ask for modifications or clarifications and in some cases you do not oppose or you do not agree, in general I believe we are heading in the right directions.

I want to tell you that we will stay in close touch with you.

Mr. Secretary, we will proceed to the next panel. Will you be here as we go forward the rest of the day.

Mr. CHAPOTON. Mr. Chairman, we will have a representative here.

Chairman PICKLE. I thank you for your testimony. It has been very helpful because we have been waiting to see what Treasury would recommend in these situations.

Thank you.

[The following was subsequently received:]

[illegible]

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[illegible], COUNSEL TO THE MINORITY

June 8, 1988

The Honorable O. Donaldson Chapoton
Deputy Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
Room 3330
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Chapoton:

I want to thank you for your testimony at the Oversight Subcommittee's hearing on unrelated business income tax held May 9, 1988.

To complete our hearing record, I am forwarding follow-up questions submitted by Representative Byron L. Dorgan concerning investment income received by exempt organizations through various pass-through entities. I would appreciate having your responses to the questions by the close of business, Friday, June 24, 1988.

Your attention to this matter is greatly appreciated. If any assistance is needed, please contact Rusty Guritz, Counsel, at 225-5522.

Sincerely,

Jake Pickle

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/phl
Enclosure

cc: The Honorable Byron L. Dorgan

Questions Regarding MLPs and the UBIT

The Revenue Act of 1987 deemed all income received by an exempt organization through an MLP to be unrelated business income regardless of the underlying character of the income.

1. The UBIT is imposed on investment income received through MLPs even though the UBIT would not apply to the same investment income if the exempt organization owned the asset directly! Do you support this penalty on exempt organizations that receive passive income indirectly rather than directly?

2. Exempt organizations may receive investment income tax-free through other types of pass-through entities, such as REITs, RICs, and grantor trusts. Do you think that the UBIT should be based on the type of entity that an exempt organization invests in rather than the type of income that it receives?

3. An MLP investment is not more risky for exempt organizations than investments in other pass-through entities. Why are we singling out MLPs as taxable investments for exempt organizations?

Response to written questions submitted by Cong. Dorgan:

1. The theory behind subjecting to the UBIT investment income received by an exempt organization from a MLP is that such income should be subject to at least one level of taxation. While we have some questions about the means used by Congress to achieve its end in this case, it is not unusual under the the tax code for tax to vary if an investment is made indirectly rather than directly.

2. While passive income has long been exempt from the UBIT, it is not necessarily inconsistent with the UBIT to make taxation depend on the type of entity rather than the type of income.

3. Partnerships do raise questions under the UBIT not raised by RICs and REITs. There are thus special rules, such as section 512(c), under the UBIT for partnerships. Moreover, RICs and REITs, unlike MLPs, are subject to a set of special tax rules and limits. Nonetheless, to the extent that the MLP rules in fact treat similar investments by exempt organizations differently, we believe that such treatment may represent questionable tax policy and would warrant further Congressional review.

Chairman **Pickle**. Our next panel—or our first panel will be the representatives of the Internal Revenue Service, Mr. Robert Brauer. He will be accompanied by Mr. Howard Schoenfeld. Also on this panel will be the U.S. Small Business Administration, the Honorable Frank B. Swain, Chief Counsel for Advocacy.

Take your seats. The Chair will observe that as we take these panels today, we are having a mixture in some cases. We are not advocating a controversy.

We are simply trying to put the panels together as best we can. This panel is representing the Internal Revenue Service and then the Small Business Administration. I am going to ask Mr. Brauer if he will proceed.

Before we do, we will ask you to hold up a minute until everybody takes their seat again and our guests have left, those who wish to leave.

Mr. Brauer, if you will proceed. Mr. Brauer is the Assistant Commissioner for Employee Plans and Exempt Organizations.

STATEMENTS OF ROBERT I. BRAUER, ASSISTANT COMMISSIONER (EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS), INTERNAL REVENUE SERVICE, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY HOWARD M. SCHOENFELD, SPECIAL ASSISTANT FOR EXEMPT ORGANIZATIONS MATTERS

Mr. **Brauer**. Thank you, Mr. Chairman. I am delighted to be here with you this morning.

In the interest of time, I am going to ask that my statement be included in the record.

I want to just read portions of it, if I may.

Turning to page 3 of my statement near the bottom, during calendar year 1987, the IRS master file contained approximately 925,000 active entities, and the Service received approximately 400,000 information returns on form 990. The vast majority of organizations that did not file had gross receipts below the filing threshold, which, in general, is $25,000.

In the same period, the Service received approximately 30,500 returns on form 990-T, Exempt Organizations Business Income Tax Return. The tax dollars collected were $119 million. This tax dollar figure is over double that collected in the preceding year—1986, $53 million—and about four times that collected 2 years ago—1985, $30 million.

This increase in tax collection is, without doubt, good news but problems remain.

One, well over half the forms 990-T as filed not only show no taxable income and no tax due, but also report a loss.

That is, half of those filing forms 990-T have losses available to offset increases to unrelated business income.

Two, over 30 percent of the approximately 3,000 forms 990-T examined annually by the Service represent delinquent returns that were secured by a revenue agent during the examination of the related form 990 filed by the organizations. In other words, almost one-third of examined returns were not voluntarily filed on a timely basis.

Three, for those returns that were filed voluntarily, revenue agents typically proposed tax increases on forms 990-T ranging from 30 to 50 percent more than the total tax as reported by the organization on those returns. This, coupled with the number of forms 990-T picked up as a result of revenue agent examinations, suggests that there is a considerable amount of taxpayer confusion and misunderstanding in this area.

Mr. Chairman, I am going to give you oral comments before concluding.

Basically, I have had the opportunity over the past several months to visit with many of our revenue agents who examine forms 990 and 990-T. Essentially, they have left me with a couple of messages I want to bring to your attention.

First, the present law definition, substantially related definition, is a very difficult one for them to interpret. It has been in the law since 1950.

They feel they are losing ground in their fight on this area. They feel most of the decisions they have to make in this area are highly factual in nature, that their examinations require case-by-case and sometimes item-by-item consideration.

They feel that there are subjective determinations involved in their decisions and the result of all this is often different results apply in similar cases.

They wanted me to mention to you that they feel the allocation of income expenses is a troublesome one for them. They feel there is inherent incentive to over-allocate overhead and other shared expenses to reduce unrelated business income.

They feel it is difficult for them and the Service to challenge these allocations except in egregious cases.

Again, they indicate these allocation problems are basically highly factual matters and involve subjective determinations.

In conclusion, they urge me to tell you, Mr. Chairman, that they feel the law needs changing. They feel the approach that is suggested in the options that would change the rules along the lines of the industry-by-industry analysis, whereby we would adopt new standards for particular industries, is a particularly helpful way to go.

They feel they need bright line rules in this area in order to help them catch up with what is becoming a major problem for them in interpreting this area.

That concludes my testimony, Mr. Chairman.

[The statement of Mr. Brauer follows:]

TESTIMONY OF
ROBERT I. BRAUER
ASSISTANT COMMISSIONER (EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS)
INTERNAL REVENUE SERVICE
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
HOUSE WAYS AND MEANS COMMITTEE

MONDAY, MAY 9, 1988

Mr. Chairman and Members of the Subcommittee:

I am Robert I. Brauer, Assistant Commissioner for Employee Plans and Exempt Organizations. With me today is Howard M. Schoenfeld, my Special Assistant for Exempt Organizations Matters. We are pleased to be here to testify before you.

Over a year and a half ago Chairman Rostenkowski announced that this Subcommittee, led by Chairman Pickle, would conduct a comprehensive review of the Federal tax treatment of the income-producing activities carried on by organizations with tax-exempt status under section 501 of the Internal Revenue Code. The hearing held by your Subcommittee lasted five days and the hearing record fills three volumes.

At the end of March, you released the Subcommittee's preliminary discussion options regarding the unrelated business income tax ("UBIT") and requested public comment on them. The volume of wirtten comments on this release itself contains nearly 1,000 pages.

The Service has been working closely with the Treasury Department in analyzing the policy implications of the discussion options and the Treasury statement includes many of our concerns.

Our testimony will therefore focus on IRS enforcement, administration, and audit efforts in this area.

DISCUSSION OPTIONS

Last June, when the Commissioner and I testified before your Subcommittee, we noted a number of areas that create difficulties in administering the unrelated business income tax. These included problems relating to the "substantially related" test, the "regularly carried on" requirement, and the allocation of income and expenses between exempt and nonexempt activities. Having reviewed the preliminary discussion options, we believe that, all in all, they are responsive to the tax administration concerns described in our June testimony. We also believe the discussion options provide an excellent framework for a legislative resolution of the major problems in this area.

Inasmuch as the Treasury testimony covers these options in detail and covers our administrative concerns, I believe it is not necessary for me to discuss them individually. I would, however, only like to make one general observation. The proper treatment of tax-exempt organizations engaged in commercial ventures, has always been a source of tension within our Federal tax system. The precise nature of the problem and its solutions have evolved and will continue to do so. Since a perfect solution is not possible, we must find the most suitable one for the present. Moreover, since exemptions from Federal income tax represent a societal judgment on the specific kinds of activities to be encouraged, it should be important and appropriate that Congress periodically re-visit the exemption provisions and revise them or re-affirm them in the light of later events.

FORMS 990 AND 990-T AND AUDIT RESULTS

During calendar year 1987, the IRS Master File contained approximately 925,000 active entities, and the Service received approximately 400,000 information returns on Form 990. The vast majority of organizations that did not file had gross receipts below the filing threshold, which, in general, is $25,000.

In the same period, the Service received approximately 30,500 returns on Form 990-T, Exempt Organizations Business Income Tax Return.[1] The tax dollars collected were $119 million. This tax dollar figure is over double that collected in the preceding year (1986, $53 million) and about four times that collected two years ago (1985, $30 million).[2]

This increase in tax collection is, without doubt, good news but problems remain.

1) Well over half the Forms 990-T as filed not only show no taxable income and no tax due, but also report a loss. That is, half of those filing Forms 990-T have losses available to offset increases to unrelated business income.

2) Since 1985, the number of Form 990-T returns filed has increased by only approximately fifteen percent annually (23,433 in 1985; 27,379 in 1986).

3) Over 30% of the approximately 3,000 Forms 990-T examined annually by the Service represent delinquent returns that were secured by a revenue agent during the examination of the related Form 990 filed by the organizations. In other words, almost one-third of examined returns were not voluntarily filed on a timely basis.

4) For those returns that were filed voluntarily, revenue agents typically proposed tax increases on Forms 990-T ranging from 30% to 50% more than the total tax as reported by the organization on those returns. This, coupled with the number of Forms 990-T picked up as a result of revenue agent examinations, suggests that there is a considerable amount of taxpayer confusion and misunderstanding in this area.

The precise causes for these conditions are far from certain. They do, however, indicate a need to clarify the rules in this area and to communicate the rules to exempt organizations.

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[1] These 30,500 Forms 990-T represent only slightly more than seven percent of the exempt organizations that file Form 990 and about three percent of the active entities on the Master File.

[2] Since 1985, the number of Form 990-T returns filed has also increased, but not as rapidly, on an annual rate of about 15% from 23,433 in 1985 and 27,379 in 1986.

PRESENT AND FUTURE IRS PLANS

The Service initiated a Taxpayer Compliance Measurement Program ("TCMP") survey of Form 990-T returns. Because the audit phase of this survey extends through March 1989, survey results are unlikely to be available until some time in 1990. The Service is also gathering data from all Form 990 examinations where the agent proposes an increase in tax liability on Form 990-T in order to provide more information on compliance with the UBIT provisions. The 990 data will be available at about the same time as that from the TCMP survey.

Improving and simplifying exempt organizations' reporting of business activities is a priority for the Service. The Service is exploring several alternative methods to enhance reporting of useful data on the Forms 990 and 990-T returns. We have already discussed preliminary options in this area with representatives from the SBA. We expect to be able to discuss these reporting alternatives further in the next several months and intend to include the exempt organizations community in developing, refining, and finalizing these alternative methods. We also intend to coordinate possible revisions on the Form 990 with the States to ensure that IRS Form 990 is continued to be used as the uniform financial report for Federal and State reporting purposes.

RECOMMENDATIONS AND CONCLUSIONS

We believe the attention generated by this Subcommittee on UBIT problems has already proved beneficial for tax administration in this area, as the dramatic rise in UBIT tax collections witnesses. The kinds of changes contained in the discussion options can provide additional guidance to tax-exempt organizations and the Service in ascertaining when a UBIT liability is due.

We shall now try to respond to your questions. Should you so desire, Mr. Chairman, the Service stands ready to continue working with you along with the Treasury Department in providing whatever assistance we can in finding satisfactory and workable solutions in this area.

Chairman Pickle. We thank you for your general opinion on it. Mr. Swain.

STATEMENT OF FRANK B. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. Swain. Yes, sir.

Chairman Pickle. Mr. Frank Swain representing the Small Business Administration.

Mr. Swain. I am pleased to be with you this morning to present my views on the subcommittee's options. As the subcommittee well knows, we have commented explicitly on the particular provisions. Those comments have been included in the subcommittee's print.

I have a brief statement this morning to highlight.

I think it is particularly ironic that this hearing is being held this morning. The President proclaimed this week as Small Business Week. In about 2 hours, small businessmen and women from each of the 50 States will be attending an awards ceremony at the White House.

This is a key issue to small business. I think they are appreciative of the time and effort the subcommittee has taken to attempt to solve these difficult issues.

Exemption from income taxes provided to nonprofits in section 501(c) of the code is the purest example of the Tax Code used as an instrument of social and economic change. Like all exceptions to the general rule of taxation, Congress created safeguards in order to ensure the desired activity would be focused on the intended beneficiaries and the objective efficiently achieved.

In other words, from the small business objective, UBIT is meant to achieve two purposes: To prevent nonprofits from using their special status in unfairly competing against small business when engaging in commercial activity and to encourage nonprofits to confine their commercial activity to areas which further the fundamental purpose of the organization.

When nonprofits are able to escape income tax on their commercial activities in direct competition of small business, the essential purpose of the UBIT is challenged. It does not promote economic efficiency to exclude healthy competition by small business nor does it serve the purpose of the subsidy to encourage an activity by nonprofits that is already being provided by the for-profit sector.

The issue before us is whether or not the purpose for the enactment of the UBIT could be better served. For small business, the issue is one of fundamental fairness in the treatment of like commercial activities.

Our comments are on three issues. First of all, whether as a whole the code ought to retain a substantially related test as opposed to the two types of substitutes the subcommittee proposed.

As Mr. Brauer suggested, the substantially related test has been around since 1950. I think that Congressman Schulze referred earlier to the fact that there have been some other tests enacted, most recently by the committee relating to shelters, material participation.

Isn't that being enforced more assiduously than the substantially related tests? I can say having read several of the thousands of court cases that interpret the substantially related test, it is difficult sometimes to predict where a particular court may come out on that test.

I think it is appropriate that the committee revisit those definitions under that test.

We believe the best approach is a strong general standard applicable to all situations, including unforeseeable areas today where nonprofit competition issues may occur in the future.

Listing specific activities considered inherently commercial is helpful, but in the end, not a full substitute for strengthening the general test.

On the specific activities options, I think that our comments lay out our explicit reactions to some of them. We believe that by and large, they represent fairly modest changes, if indeed any changes at all, in what most observers would see to be the current state of the administrative law.

From the standpoint of predictability, I think the options are well thought-out and highly appropriate. But are concerned some of the specific exceptions will continue broad exceptions and safe harbors to the general rule of taxability of commercial activities which have brought us together in the first place 1 year ago.

In several instances, we suggest that the committee tighten up the definitions. Let me give an example. In the area of distribution of related products or services, rental of medical equipment and so on, the committee suggests that there might be an exemption available if the product were not locally available.

First of all, that seems to me to throw the IRS into a difficult situation of deciding what is local. It doesn't necessarily take into account the fact that we have a lot of catalogue sales.

Third, it doesn't take into account the fact that in a rural area or a smaller town, that a nonprofit is already selling something, that is probably enough competition to keep profits from starting in the first place.

I think the code ought to recognize that in any given potentially competitive situation, there will likely be for-profit businesses that will attempt to provide the service. A geographic test is really not an appropriate test for the committee to adopt into law, although I will note that I have read some court cases in which the judges tried to draft it into law.

I would like to mention briefly, we are firmly in agreement with the committee's recommendation for better data collection. We believe that the committee should urge the service to do two things through its forms. No. 1, to separate sources of commercial income by category, something that is not adequately required in the forms now. Second, to link the amount of income back to the specific sources.

I suppose one would argue that the Service is already technically legally capable of doing that. It doesn't necessarily require the committee to change certain forms. It is a controversial area.

Chairman PICKLE. With the IRS, is that possible, to specifically identify the source of income?

Mr. BRAUER. I think it is. We are working toward that aim. We feel we need increased information reporting.

Chairman PICKLE. All right. Go ahead.

Mr. **Swain**. I might also add, Mr. Chairman, that we do not object in fact, we would endorse an increase in the exemption for no filing at all for the first $5,000 of unrelated business income tax, possibly up to $10,000, and phasing that out on income of over $50,000.

Chairman **Pickle**. Do you agree with that amount?

Mr. **Brauer**. We believe that is a policy matter. We have no particular administrative concern except if it went to a point where almost no returns were being filed. If we raised it to $10,000, more than 50 percent of the organizations that file a 990–T would no longer be required to do so. I think that should be looked at further, at least in terms of the limit.

Mr. **Swain**. The reason we endorse that is we have experience with small businesses being frustrated over Federal forms and regulatory requirements. The same arguments can be properly made on behalf of small not-for-profit institutions.

Second, I think the locus and the extent of the commercial activity that has been the most frequently subject to complaint is primarily, probably by a relatively few number of institutions engaged in a relatively large amount of commercial transactions.

To the extent that there are increased requirements in the law, those institutions are perfectly capable of hiring legal accounting or technical talent to construct their activities in keeping with however the law may change.

If we can relieve reporting on the very smallest institutions where the net effect of their so-called commercial activity is negligible, I think that is an appropriate balance. I think it is a balance that can only be struck if the law itself is tightened in the first place.

I would like to commend the subcommittee for proposing significant options. Small businesses seek a competitive environment in which all participants play by the same set of tax rules. I urge remedial legislation in this Congress.

Thank you, Mr. Chairman.

[The statement of Mr. Swain follows:]

STATEMENT OF HON. FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you to present my views on the Subcommittee's options for revising the unrelated business income tax (UBIT) as released March 31, 1988. You are to be commended for your efforts to bring this important issue to the forefront of tax policy debate and to propose specific options to remedy the inadequacies of current law. It is appropriate and timely that the Subcommittee has chosen to comprehensively reexamine this area of the law.

As you know, the Office of Advocacy first raised this issue more than four years ago, and it emerged from the White House Conference on Small Business as the third most important concern to the over 2,000 delegates. According to their resolution:

> Government at all levels has failed to protect small businesses from damaging levels of unfair competition. At the federal, state, and local levels, therefore, laws, regulations, and policies should...Prohibit unfair competition in which nonprofit tax-exempt organizations use their tax-exempt status and other advantages in selling products and services also offered by small businesses.

Before discussing the relative merits of the specific options proposed by the Subcommittee, I would like to first take this opportunity to place our important discussion today in perspective. As this Subcommittee well knows, the Internal Revenue Code is used as an instrument of social or economic change as often as it is a means of raising revenue. Within the Code, all exceptions, deductions or credits are created with the desire to encourage a particular activity when it is believed that, without such encouragement, gaps in the marketplace would prevent the goods or services from being supplied in sufficient quality or quantity. The exemption from income tax provided nonprofits in Section 501(c) of the Code is perhaps the purest example in that it exempts whole entities from taxation that are organized primarily to serve certain enumerated social purposes. Like all other exceptions to the general rule of taxability, however, Congress created safeguards in order to ensure that the desired activity would be focused on intended beneficiaries and the desired social objective efficiently achieved. The principal safeguard developed for this purpose is the unrelated business income tax (UBIT), which is under criticism today.

In sum, the UBIT is meant to achieve two important purposes: (1) to prevent nonprofits from using their special status to unfairly compete against small business when engaging in commercial activity; and (2) to encourage nonprofits to confine their commercial activity to areas which further the fundamental purposes of the organization. When nonprofits are effectively able to escape income tax on commercial activities in direct competition with small businesses, the essential purpose of the UBIT is challenged. It does not promote economic efficiency to artificially exclude healthy competition from small businesses. Nor does it serve the purpose of the subsidy to encourage an activity which is already being provided by the for-profit sector.

The issue before us is not whether the particular exemption should still be granted, but rather, whether or not the purposes for the enactment of the UBIT could be better served. For small business, the issue is not one of increased revenue, but of fundamental fairness in the treatment of like commercial activities.

I wish to stress that the views expressed herein are wholly my own and do not necessarily represent those of the Administration. My testimony today builds upon my testimony before this Subcommittee on June 22nd, 1987 and will briefly highlight my letter to the Subcommittee of April 15, 1988 on the proposed options. I would appreciate your making that letter part of the record of this proceeding.

I would like to particularly draw your attention to three of the options discussed in the March 31, 1988 release. My main recommendations with respect to these options are:

- Narrow the definition for the "substantially related" test;
- Eliminate broad exceptions and safe-harbors to the general rule of taxability, if an inherently commercial approach is adopted, and;
- Provide specific guidelines for improving data collection and analysis.

Tightening the "Substantially Related" Standard

The debate on commercial activities of tax-exempt organizations has been, in many cases, stimulated by activities which were not predicted in 1950 or 1969 when Congress last examined this issue. The best legislative approach, therefore, is a strong general standard applicable to all situations, including unforeseeable areas where nonprofit competition issues may occur. Listing specific activities that are considered "inherently commercial" is not an appropriate substitute for strengthening the general test.

Included in the "discussion options" is a proposal to replace the "substantially related" test for determining the taxability of an exempt organization's activity, with a "directly related" or "standing alone" test. Under these alternatives, an activity must either be "directly related" to the exempt function or must be able to "stand alone" to fulfill the exempt purposes of the organization as a condition of nontaxability.

While I do not recommend replacing the substantially related test at this time, I believe it is essential to significantly narrow the scope of the activities which are considered "substantially related" to an exempt purpose. In particular, I recommend that the "substantially related" test be better defined, along the lines of the "standing alone" test, by exempting from taxation only those income-producing activities which are so fundamental to the organization's exempt purpose as to be a mere extension of it. This would not fully reject the "substantially related" test; rather, it would limit the privilege of exemption to those activities which fulfill the primary purpose of the exempt organization.

Critics of tightening the overall standards for determining the taxability of an activity point to potential uncertainty in the law that such a change may engender. As indicated in the testimony of many witnesses before the Subcommittee this past June, however, including the Internal Revenue Service, the current standard is neither uniform nor predictable and has produced hair-splitting and irreconcilable distinctions. Indeed, the "substantially related" test permits many activities which compete directly with small business to avoid taxation, rather than fulfilling its principal function of protecting those business from unfair competition stemming from the exemption. Recent data showing that few tax-exempt organizations reported unrelated business income during a period of increased reliance on commercial income is strong evidence of this fact. In fact, since attention has been drawn to this issue, UBIT revenues have increased four-fold; from about $30 million in 1985 to $120 million in 1987. A tighter definition would greatly clarify the boundaries of permissible activity for managers of tax-exempt organizations, enforcement officials and the courts, and go far towards a permanent solution to this problem.

It is important to bear in mind that the taxation of commercial activity will not, by itself, preclude a nonprofit from engaging in such activity. It merely places them on an equal footing with small business if and when they choose to do so. Some have expressed concern that tightening the substantially related test will discourage some favored nonprofit activity, but this concern must be balanced with concern for the impact of failing to tax activity known to compete with small business.

Taxing Specified Commercial Activities

The Subcommittee also has proposed to tax certain "inherently commercial" activities of nonprofits without regard to their relationship to the exempt purpose; such as, gift store sales, sales of medical devices, health and fitness activities, veterinary services and travel and tour services. While this approach properly identifies many competing activities as "inherently commercial," the broad exceptions and safe-harbors to the general rule of taxability which are also proposed will allow a significant, and in some cases an even greater amount of commercial income to escape taxation. Other exceptions proposed by the Subcommittee merely codify established interpretations of current law. The problems associated with these "inherently commercial" activities can only be remedied if the exceptions are eliminated or severely curtailed.

For example, the Subcommittee should limit the exceptions provided for gift store/bookshop income. While bookstore income is considered "inherently commercial" under the option, "de-minimus" off-premise sales by universities are exempted to the extent of on-campus sales. Through this so-called "de-minimus" exception, universities can earn the right to generate one dollar of tax-free income for every dollar earned from on-campus sales.

Second, the exceptions provided for the sale or rental of medical equipment and devices, laboratory testing, and pharmaceutical drugs and goods are largely undefined in scope. I recommend restrictions on the definition of a continuous-care patient so that health care facilities are not granted captive markets. The Subcommittee should also recognize that excepting from UBIT items which are not available in an immediate geographic area will serve as a barrier for entry to small business. Small businesses are highly flexible and competitive. To the extent a demand exists, small firms will form to meet such demand, unless artificial barriers, such as the tax exemption of a competitor deter them from doing so.

Third, I suggest that the Subcommittee develop standards to ensure that the benefits of the subsidy provided for health and fitness facilities actually reach the intended parties. I would note that considerably fewer restrictions are imposed on the use of this subsidy as are imposed on other tax incentives designed to assist the needy, such as the low-income housing credit. These and other recommendations with respect to specific exceptions are set forth more fully in my written comments of April 15, 1988.

Better Data Collection

Representatives of both tax-exempt and taxable organizations agree that the present reporting system is inadequate. Currently, the nonprofit business and informational tax forms do not request sufficient information to determine the sources or amounts of nonprofit commercial activity. Neither do these forms distinguish between activities that are related, unrelated, or excepted from the UBIT. I recommend that specific guidelines be developed for modifying the tax-exempt data collection instruments. In particular, Form 990 should separate commercial income by the business activity codes into categories defined by the Internal Revenue Code (i.e. related, unrelated or excepted). Similarly, Form 990-T should link the source of unrelated income to the amount it generates. We have developed specific proposals to modify the forms and would be happy to share these proposals with the Committee and its staff.

Along with the need to improve data collection is the need to improve statistical programs that analyze such data. Requiring annual reports on data derived from forms 990 and 990-T would provide a time series of information useful for both enforcement and policy purposes.

Finally, additional data are also needed on the extent of tax subsidies granted to tax exempt organizations. The Congressional Budget Act of 1974 (P.L. 93-344) requires a listing of tax expenditures in the annual budget analysis, which are defined to include "revenue losses attributable to provisions of Federal tax laws which allow a special exclusion, exemption or deduction..." Revenue losses for the tax-exempt sector, however, have not been estimated by the Federal Government in the same manner as are the expenditures for other tax subsidies.

Conclusion

The success of small business and its continued ability to provide opportunity for entrepreneurs depends to a large degree on the business environment in which they function. For years, tax exemptions and other advantages granted nonprofits which engage in commercial activity has placed small business at a serious disadvantage. It has deterred for-profit business from entering fields whose markets and technologies have expanded beyond the point necessitating subsidies and brought tax-subsidized competition to additional markets in which nonprofits have expanded their commercial activity. The vague contours of the substantially related test, the broad exceptions in current law, and the loose allocation rules have allowed nonprofits to earn nontaxable income from activities never contemplated by Congress in carving out their original exemption. The distinction between the two sectors has become blurred--in some instances beyond recognition.

I commend the Subcommittee for proposing specific options for redressing these inequities. Small businesses so not seek to eliminate competition. They seek a competitive environment in which all participants play by the same set of tax rules. I urge the Subcommittee to recommend remedial legislation now as an essential step in creating such an environment.

Chairman **Pickle**. Thank you. I appreciate your analysis that you want to have an even playing field so it can be competitive. Do you think we can advance either corrections or legislation or recommendations that would be fair to both?

Do you think we can reach a better level than we have at this point?

Mr. **Swain**. I very much think so, Mr. Chairman. I think your recommendations go a long way towards getting there. I think we are in somewhat the same position as Mr. Chapoton. There are some we agree with more than others. There are some nuances that we are more in favor with than others.

There has been a very full record here. Through our hearings and the record of comments the committee has a lot of information that should allow it to make decisions in a number of these areas.

Chairman **Pickle**. I want to ask Mr. Brauer. You make four points that are impressive to me. First, you said half the 990–T's not only show no taxable income, but no tax due. In other words, you are saying half of those tax-exempt organizations that filed the 990–T's, have losses available to offset the income and therefore pay no tax.

Do you suppose, is that just the way the facts are, or did some organizations seek to reach that balance? How do you analyze that at least half of them show no tax at all?

Mr. **Brauer**. That is one area that in our TCMP study now ongoing and in the related study being done by our statisticians that we hope to arrive at firm conclusions. It does convince me that there is certainly a problem in this area, and that there are many opportunities for exempt organizations to avail themselves of provisions of the statute that allow them to come up with losses or with no income in these situations.

It is troublesome to me. Hopefully, when our studies are completed, we will understand the reasons for this.

Chairman **Pickle**. I notice since 1985, the number of 990–T's returned has increased by only 15 percent. In other words, there are very few of the 990–T's being filed. The last counting, I guess, is in 1986. Do you have any figures at all about 1987?

Mr. **Brauer**. We do not have the figures for 1987, because those are just being filed now, Mr. Chairman. And so, we do not have those figures.

Chairman **Pickle**. I guess we have to say factually that very few of them are being filed. Only a small amount of increase is being shown, at this point 15 percent.

Mr. **Brauer**. There is a 15-percent increase the past couple of years, probably more than we had in the past. I think it is fair to say there is an additional awareness being given to this area, as witness the fact the corrections have gone up so significantly.

Chairman **Pickle**. You say almost one-third of the combined returns were not voluntarily filed on a timely basis?

Mr. **Brauer**. That is correct. Our agents in the course of their examinations very carefully looked for the presence of unrelated business income.

Chairman **Pickle**. Why do you think they are not voluntarily filed on time?

Mr. Brauer. I think to a large extent, it is lack of knowledge on the part of the organization as to when they should be filing a form 990-T to report unrelated business income.

Chairman Pickle. Are you saying the organizations don't know when to file?

Mr. Brauer. I think they do not know to file. Many of them are very small organizations and do not understand the law.

Chairman Pickle. What are you doing to correct that?

Mr. Brauer. We basically look for the existence of unrelated business income. If there is unrelated business income, we cause a return to be filed.

Chairman Pickle. I notice you said that revenue agents propose tax increases ranging from 30 to 50 percent more than the total reported by the organization. In other words, I presume you are saying the organizations underestimate their income?

Mr. Brauer. Yes.

Chairman Pickle. By 30 to 50 percent?

Mr. Brauer. Yes. There is confusion out there causing people to file returns or not to report the proper amount of income.

Chairman Pickle. I am hoping we show as we get more information, I think we must keep in mind that I don't think we ought to point a finger at anybody, either, at these organizations, or to Congress or to the institutions or the Treasury. We just simply have to look at this in 20 years.

People become bolder in what they don't have to file. People have become too bold in some instances.

Mr. McGrath. Are you saying people are underestimating their income or overestimating their deductions?

Mr. Brauer. Both come into play as a practical matter.

Mr. McGrath. On balance, which is more prevalent?

Mr. Brauer. It is not possible for me to say now. That is one of the items we will cover in the studies we have ongoing.

Chairman Pickle. Mr. Schulze, do you have any questions?

Mr. Schulze. Thank you, Mr. Chairman.

I would like to ask Mr. Brauer the same question I asked of the Secretary in regard to substantially related and material participation. It seems to me both terms are either as implicit or vague as you would want them to be.

I wonder why there seems to be a big problem in the enforcement of those terms?

Mr. Brauer. Mr. Schulze, my view of it is that we have had the substantially related test in the law now for 38 years. Expressing my personal view, I see a situation over the years, courts have tended to rule in favor of exempt organizations in these matters.

There have been instances where the Congress has passed legislation to overturn an issue that an agent of ours raised. And administratively, I think, we have tended to look to those items and to come up with conclusions that reflect the general tenor of the time.

My sense of it is that we have, as I mentioned earlier, been losing ground in this area rather than things have been remaining equal over this 38-year period of time.

The other provision you mention is a new one. I really can't predict what will happen over the next 30 years.

Mr. SCHULZE. You are saying that material participation may go the way of substantially related?

Mr. BRAUER. Yes.

Mr. SCHULZE. Mr. Swain, could you give me the top three or four or five ranking options?

Mr. SWAIN. No. 1, whatever efforts the committee could succeed with in tightening up by direct legislation or legislative commentary, your view of the substantially related test. That is the basic test which has led us to this confusion in the first place.

Now, that is difficult, as most commenters have pointed out. The options that the committee has proposed have not met with great success. I would be more inclined towards something akin to the standing-alone test, that an activity would, standing by itself, have to further the exempt purposes of the organization.

As some commenters pointed out, the most frequent example is what about the college dormitories? Then I think you shift your Roman II, items A through L and you add an M for college dormitories. There are some industry sectors where the activities are peculiarly unique to require separate tax treatment.

No. 1 would be the basic test. No. 2 would be an implementation of some variation of your options—of some of the options—A through L. Obviously, they are industry-specific. People that are interested in health clubs are more interested in that option than people that are in the retail store business, which are obviously most interested in option A that would limit the UBIT exemption on stores.

I would say from the small business perspective, a third item that is not covered explicitly by your options is grappling with the research issue. We commented in our statement to the committee on the options that the whole issue of research tends to be pretty muddled, because there are different definitions in the tax law and other Federal laws for different purposes.

We think the committee has got to get a handle on this issue. When money flows to not-for-profit institutions that perform research for the public good and which is publicly available, that should be tax-exempt. And when money flows to not-for-profit institutions for what I would call proprietary research, that has some specific commercial advantage that accrues to some individual entering in the near future, that is applied research. That revenue ought not to be exempt from taxation.

Mr. SCHULZE. Thank you.

Let me say it would be my intention, and I have not discussed this at length with the chairman, that no matter what we do and where we do it this year or next year, whenever we do take action, and whatever that action is, to revisit this issue in perhaps 3 to 4 years.

If the steps we take now are initial steps, then there are things which we will be watching over a period of time. I believe it is fairly important that we don't make some changes, walk away from this and not come back for 20 years. I believe it would be our intention to keep an eye on it so we make sure what we do is right, and if it needs fine-tuning, we will revisit in a few years and fine-tune it.

Thank you, Mr. Chairman.

Chairman PICKLE. The committee generally recommended that we combine this effort, the agencies involved, at least, and give us a report at least every 5 years. That is recommended now. It is my feeling we will proceed this year with some recommendations in this field and keep a close eye on these activities in the years that go down.

Mr. Rangel.

Mr. RANGEL. I have no questions, Mr. Chairman.

Chairman PICKLE. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Mr. Swain, at a recent White House Conference on Small Business, is it not so that this particular issue, the competition issue, was articulated by the Small Business Conference as being one of the largest issues at that conference?

Mr. SWAIN. Yes, it is, Mr. McGrath. At the White House Conference that was held in 1986, the result of some 63 meetings held in every State of the Union the small business community at large was asked to rank in terms of their priorities the public policy issues. This was the third ranking priority to straighten out—this issue of what the small business community regards as commercial competition by not-for-profits which enjoy a deference of tax rules—ranking ahead of such issues as increasing allowance for small firms or international trade.

Mr. MCGRATH. Mr. Brauer, does a university that advertises commercial films in a catalog that would be in competition with, let's say, "Erol's" here in town, does that fit under the substantially related test?

Mr. BRAUER. I would have to probably tell you that we would have to take a look at the particular facts that are involved. The university would have to show the nexus to its exempt organization. It is hard for me to imagine that it would be able to in that situation.

But I would want to take a careful look at the exact facts before giving an opinion.

Mr. MCGRATH. How about a university that has a gas station on campus? Does that conform to the convenience of the students and faculty test?

Mr. BRAUER. Once again, I would think, unfortunately, in all these cases it is very much a factual situation. And I would want to look at that situation before rendering an opinion.

Mr. MCGRATH. To add some more facts, there were three other gas stations on the perimeter of the campus. Would that give you any more information to make that determination?

Mr. BRAUER. In other words, there were three commercially operated gasoline stations, yet the university was operating its own station?

Mr. MCGRATH. That is correct.

Mr. BRAUER. I would think one would have to look at the connection of the station, whether it was a convenience item, and make a determination on that basis.

Mr. MCGRATH. Have you ever heard of a campus or a university operating a gas station for the convenience of the students from any of the 990–T's that you have seen?

Mr. BRAUER. The only situation I recall that is close to this is one I heard you mention on a prior occasion. I am not aware of any universities in the country that have a similar question.

Mr. MCGRATH. I sound like I am bashing universities, but I am really not. I went to two or three myself. Some of these universities today have a dormitory complex, a health facility with tennis courts, swimming pools or whatever, and there are four hotels in the area. Does it meet the test of substantially related or regularly carried on test if they should bid against these hotels for conventions of the American Legion or the VFW or something like that?

Mr. BRAUER. I suppose under the current law, it would depend in part if they had a particular course in hotel management.

Pardon?

Mr. MCGRATH. This is strictly for the use of the facilities in direct competition with hotels in the areas. Is that covered under the regularly carried on test? Can that be permitted under regularly carried on or substantially related tests?

Is there any way under the UBIT law now that that university should either be precluded from doing that or have to pay taxes on income derived from that kind of activity?

Mr. BRAUER. There are—there is a rental income exception. Perhaps I could ask Mr. Schoenfeld to go into that a bit more for you, Congressman.

Mr. SCHOENFELD. If substantial services are performed in connection with the rental of the hotel-type, dormitory-type facilities, in a straight rental arrangement, then the income from that would fall within the current exemption in present law for rental income from real estate, real property.

Mr. MCGRATH. Thank you, Mr. Chairman.

Chairman PICKLE. Let me ask either one of you gentlemen, many groups have commented to us that we really don't need to make changes in the unrelated business income tax area, that what we need is better IRS guidance or better IRS enforcement. Do you agree?

Mr. Swain, let me ask you that first.

Mr. SWAIN. I think at least from the standpoint of most business people that I talked to, when it comes to enforcing business taxes, they are not the first to stand up and say IRS needs to do it better. I think most business people, particularly small business people, think the IRS enforcement mechanism is pretty good as it is.

The issue is not so much what level the law is being enforced at, whether at an IRS audit, or in a court where there is an official challenge, but what the standards are. Indeed, the standards are—a word used earlier was murky. They are very murky in some areas. Facts speak very loudly.

The UBIT collections have quadrupled in the last 3 years. In 1985, there were some $35 million. There are nearly $120 million. Excuse me, in 1984, there were $35 million. In 1986, there were $120 million. Am I implying nonprofit entities are tax cheats? No. I am implying there is a lot of wiggle room in the law for the amount of unrelated business income tax to increase at that proportion over just 2 years for obviously the economic activity has not changed that greatly.

The law is murky and I think is ripe for congressional clarification.

Chairman PICKLE. Mr. Brauer, do you believe all we need is better IRS guidance?

Mr. BRAUER. No. I believe we need to strengthen the law. I believe we have lost ground in the past period of years, and we can strengthen the law now by taking this activity-by-activity approach in changing the law and doing so this year.

I also believe that with the studies we have ongoing, before we make changes in the basic definitions in the law, we should perhaps await the results of these studies. I do not share the view that the problem here is one of lack of enforcement. I think we have reasonably good coverage in this area.

I think from the fact we pick up a lot of 990-T unrelated business returns, you see we do enforce this area. Our agents very much are interested in uncovering unrelated business income where it exists.

Chairman PICKLE. Some of the exempt organizations have commented to our committee that the proposed allocation rule in the discussion options runs counter to good tax accounting principles. Do you agree with that?

Mr. BRAUER. Our agents feel the allocation issue is the biggest issue by far facing them. They feel that the availability of allocation options to the organizations, to the exempt organizations, is to the point where they can do pretty much as they please. They feel a tightening is very much in order.

Chairman PICKLE. Very much in order?

Mr. BRAUER. Yes.

Chairman PICKLE. Mr. Schoenfeld, would you agree with that?

Mr. SCHOENFELD. Absolutely.

Chairman PICKLE. All right.

I want to say to both of you gentlemen that we are going to proceed, and we are going to go through the luncheon period, for the audience's information also. But we are going to ask you to stay because we may have other questions from panels. We may ask you if you have any commentary you might want to make on it.

We would like for you to stay here. We are going to stay in close touch with you two gentlemen as we proceed to consider the various options, and what course we take on these options. I thank you very much. I appreciate your testimony.

Our first witness then will be Mr. Mathew Ahmann. He is associate director of the Catholic Charities.

Then we will have testimony from Mr. Harrison Wellford, National Assembly of National Voluntary Health and Social Welfare Organizations, Grants and Contracts Project; Dr. Caspa Harris, representative of the National Association of College and University Business Officers; and Joseph O'Neil, representing the Business Coalition for Fair Competition; and then Wayne Smith of the Small Business Council.

Mr. Ahmann, if you will proceed now. All of your statements will be included in the record. We have asked each one of you to try to summarize in the interest of time. I think our staff is asking you to stay with the 3-minute limitation as much as possible. All of your statements will be in the record. Is that agreeable? Mr. Ahmann, you may proceed.

STATEMENT OF MATHEW AHMANN, ASSOCIATE DIRECTOR, CATHOLIC CHARITIES USA, REPRESENTING THE INDEPENDENT SECTOR, ACCOMPANIED BY WALTER SLOCOMBE, COUNSEL

Mr. AHMANN. I am accompanied by Walter Slocombe, counsel on this issue. We want to add our appreciation to those that have been extended to you already for the process that you began last year, which we think has proved healthy and helpful to date.

I also was very encouraged to hear you say that the committee would take a look at issues in this area every 4 to 5 years. I think that would be very helpful for the nonprofit sector. Independent Sector has a task force of national organizations with local affiliates dealing with the UBIT question, and that task force selected four issue areas that cut across much of the nonprofit sector, and didn't deal with things that are specific to higher education, or whatever.

We are concerned about the question of the overall standard. On the question of improved reporting of unrelated business income, we have submitted today with our testimony some concrete recommendations in respect to this. We are concerned about the fundraising and program impacts that some of the provisions in the options document would raise. We are concerned that in the allocation of expenses, indirect costs be deductible on a reasonable allocation basis just as they would be for another business. And we are concerned that dealing with the royalties in the way the options suggest would begin to breach passive income for nonprofits.

I want to say two things: One is the specter of some large windfall tax piece that was raised earlier in the comments of the Treasury that there might be $5 billion in revenue lying around in the 38 percent or so dues, fees and charges attributed as income to nonprofits. This figure is taken from Dimensions of the Independent Sector, published by the Independent Sector, and we asked them to break it down, break the category dues, fees and charges down much further than it is in the publication. If we project that data to 1986, most of what is in that category is tuition and health payments. You come down ultimately to dues, fees and charges other than health charges or tuition of roughly 4.7 percent of nonprofit income. I think you are really dealing with a much different ball of wax when you look at what is taxable and what revenue might be there.

The second point, major point, I want to make is our deep concern about the overall standards issue raised in the option's document. We look forward to the studies the Treasury is initiating at your request, and we appreciate their concern that for the moment we stay with the substantially related test, which we have had in the last 38 years and around which there is a good deal of case law and rulings. We find the specter of using the term "inherently commercial" to describe an activity very disturbing because it doesn't really look at either the context of the activity or the purpose of the activity, and if you take a look at direct and indirect and inherently commercial in the option document, depending on who was drafting the legislative language, it is conceivable you could come out with all income of nonprofits being taxed except their charitable contributions, which we know isn't the intent of the committee. But the vagueness of the lack of definition around those terms troubles us a great deal.

Thank you, Mr. Chairman.

[The statement of Mathew Ahmann follows:]

TESTIMONY
OF
INDEPENDENT SECTOR

1828 L Street, N.W.
Washington, DC 20036
202/223-8100

Presented by Mathew Ahmann, Associate Director of Catholic Charities USA, 1319 F Street, N.W., Washington, DC 20004, 202/639-8400; accompanied by Walter Slocombe, Esq., Caplin & Drysdale, One Thomas Circle, N.W., Washington, DC 20005, 202/862-5071.

I am Mathew Ahmann, Associate Director of Catholic Charities USA. Accompanying me is Walter Slocombe, counsel to INDEPENDENT SECTOR. I have been chairing the INDEPENDENT SECTOR Steering Group on UBIT and Competition for about two years, and I am testifying for INDEPENDENT SECTOR's Steering Group on the Unrelated Business Income Tax, comprised of 40 INDEPENDENT SECTOR members. INDEPENDENT SECTOR consists of 650 corporate, foundation, and voluntary groups.

Overall Standard. The current "relatedness" test is a fundamentally sound standard for identifying activity that is integral to exempt activity and therefore should not be taxed. Describing the required relationship as "direct" instead of the current "substantial" would erase 38 years of accumulated interpretation of the law, and would create great uncertainty as to what, if any , change was intended.

There are profound problems with the proposed "inherently commercial" standard. It is inherently vague. Does it propose to tax an activity with no reference to its purpose, merely because for-profit businesses provide somewhat similar or even identical services to some people? If so, most of the services of most nonprofits would be taxed. Or does it propose to tax an activity simply because it is largely self-supporting? That would be inconsistent with the principle that charity is more than alms-giving. "Inherently commercial" should neither be employed as a new or supplementary standard, nor used to characterize particular activities Congress determines should be taxable under UBIT.

Improved Reporting of Unrelated Business Income. The Treasury, small business representatives, and INDEPENDENT SECTOR agree on the need for improved reporting by nonprofit organizations of unrelated business income (UBI). Improved reporting could increase compliance with UBI rules and provide a basis for further review of the relatedness test. Attached to our statement are proposals that call for a number of changes on Form 990 which, we believe, could result in improved compliance.

Fund-raising and program impacts. Many of the proposals, in their present form, would tax fund-raising and program activities that lie far removed from what are reasonably considered "business" activities.

For example, the Catholic Bishops, through the United States Catholic Conference, have a substantial publication program, communicating and teaching on moral and social issues, as well as on doctrinal matters. Yet, they maintain no bookstore. While this publishing program is intimately related to their charitable purpose, it would appear that it would be taxable activity under the inherently commercial test as off-premise sales. Indeed I raised this example with one of the members of this Subcommittee,

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and he responded immediately that this activity should be in a taxable subsidiary.

Allocation of expenses. Several of the options would deny to charities deductions of such indirect costs as overhead and depreciation. Indirect costs should be deductible on a reasonable allocation basis, just as they would be deductible by any other taxpayer, including a for-profit.

Royalties. This option would tax the passive income that a nonprofit organization derives from royalties on licenses granted for-profit businesses to use property created by nonprofits. The proposal is a concern to all charities because it breaches the principle that charities should be exempt from tax on passive income.

Attachment

ATTACHMENT TO TESTIMONY OF INDEPENDENT SECTOR

April 28, 1988

INDEPENDENT SECTOR Draft Proposal on Increased Reporting of Unrelated Business Income

The U.S. Treasury, representatives of the small business community, and INDEPENDENT SECTOR agree on the need for improved reporting by nonprofit organizations of their unrelated business income (UBI). Improved reporting could increase compliance with UBI rules and provide a basis for further review of the relatedness test. That test is, in our view, the linchpin of the UBI rules and is a workable standard to distinguish exempt income from taxable income. This standard is the most logical method for making an initial determination about the tax status of exempt activity.

While the relatedness test does represent a workable standard, it does need some fine tuning. We are aware that nonprofit organizations may be inadvertently underreporting the amount of their unrelated business income and that this underreporting may be related to the information presently required by the Form 990. The attached proposals call for a number of changes on Form 990 which, we believe, could result in improved compliance.

We are continuing to review the Form 990 and may suggest additional changes. However, we wanted to make this draft available now for those who may be considering changes in the Form 990 to elicit more accurate reporting by nonprofit organizations.

A. Past INDEPENDENT SECTOR reporting proposals.

In its September comments on Treasury's testimony, INDEPENDENT SECTOR endorsed the following specific steps:

1. Disclosure of gross and net UBI on the Form 990. This change would require a statement of the amount, as well as the fact, of UBI on the general information return, which, unlike the Form 990-T, must be made available for public inspection.

2. Development of a separate form to be filed upon the creation of a controlled subsidiaries. Such a form, which would supplement rather than replace the current question about related entities, would help identify relationships between exempt organizations and taxable entities through which they may receive income.

B. Additional reporting requirements that could be proposed include:

1. Revision of the Form 990 income statement and the instructions to define income categories more clearly. The instructions should deal more systematically and consistently with how UBI should be reported.

The present income statement and instructions are very obscure as to how UBI is to be treated. A more functional categorization of receipts might include, for example, separating out sales that are claimed to be related form unrelated sales. A revised schedule would mean that the organizations will be more focused on reporting UBIT, and the IRS better able to spot possible problems in treatment.

2. Revision of the Form 990 expense statement to include an explicit line entry for expenses of unrelated businesses.

It is unclear, how, if at all, expenses of earning UBI are to be reflected on the expense schedule.

3. Separate schedules for Program Service Revenue (to be defined as related income) and for Other Exempt Income.

a. The schedule for Program Service Revenue would require a separate identification of each class of gross revenue in excess of a certain level, say $50,000, and a brief statement of why it qualifies as related.

b. The schedule for Other Exempt Income would require a listing of all classes of gross receipts (above a threshold of, say, $50,000) that is claimed to be exempt from tax on any ground other than relatedness, with a statement of gross and net and of the basis for not including the income as UBI on the Form 990. (Listing an item on this schedule would not necessarily concede it would not qualify as related; only that it was claimed to be exempt on some other ground as well.)

These schedules would replace the current Parts III and IV, which now require, respectively, a statement of "each program service [with] output or products, and...quantity provided [and] total expenses attributable to each program service," and a "list [of] each revenue-producing service activity [with] gross revenue...from each such activity." It would also replace the current requirement, under line 78, for "a statement of your reason for not reporting...income from business activities not reported [as UBI]."

These new schedules would not require more information than the current form nominally requires, but they would concentrate the reporting in one place and would be much more explicit about what is required. Actually doing the already required reporting would encourage organizations -- both internally and in reporting -- to address directly the issue of why (and whether) their income is exempt from tax. (Sample schedules for a university are attached.)

4. Include under line 78 a question on whether any income-producing property is debt-financed.

Although there is a separate schedule on the Form 990-T for debt-financed income, there is nothing on the 990 itself to highlight the issue.

UBIT University
Other Exempt Income

Source of Income	Gross Receipts	Net Income	Basis for treating as Nontaxable
Toilet articles sold in campus shops	$ 30,000	$ 5,000	Convenience of students
Research for X Corp.	$400,000	$180,000	Research exemption of Sec. 512(b)(8)

UBIT University
Program Service Income

Source	Gross Receipts	Relation to Exempt Purposes
Tuition	$5,000,000	Payment for classroom instruction
Dorm rent	$1,000,000	Housing on campus for students

APPENDIX

Background on Reporting

I. Statutory Provisions on Reporting. The statute:

1. Generally authorizes IRS to require that information returns that include "such ... information for the purpose of carrying out the internal revenue laws as [IRS] may by forms or regulations prescribe." Sec. 6033(a)(1). Sec. 6033(b) lists specific requirements, e.g., "gross income" and "expenses attributable to such income, and authorizes IRS to require "such other information for purposes of carrying out the internal revenue laws as [IRS] may require." The current gross receipts threshold for filing Form 990 is $25,000.

2. Required reporting of relationships with other exempt organizations will be expanded as a result of section 6033(b)(9), added to the Code last year, which authorizes IRS to require information on "direct or indirect transfers to, and other direct or indirect transactions and relationships with, other [exempt] organizations."

3. There is no separate return provision for unrelated business income. The Form 990-T is required pursuant to the general return requirements of sec. 6012. Treas. Reg. §1.6012-2(e). The current gross unrelated business income threshold for filing is $1000.

4. Failure to file a Form 990 is subject to penalty under sec. 6652(c) of $10 per day, up to the lesser of $5000 or five percent of the organization's gross receipts. For returns for years beginning in 1987, the penalty also applies to "failure to include any of the information required to be shown on a return ... or to show the correct information."

> The 1987 changes impose a penalty for filing returns that, although lacking certain entries, are still sufficient to constitute a "return" for filing purposes.

5. Exempt organizations' Form 990 are subject to public inspection, both through the IRS and, for returns for years beginning in 1987, through the organization itself. Sec. 6104. The Form 990-T is not subject to public inspection.

II. Current Reporting Requirements. The 990 currently requires:

1. Part I, a full "statement of support, revenue, and expenses."

> Logically, all UBI should be included somewhere on this schedule, but there is no separate line for it, nor any very clear instructions on how to show it. For example, the instructions for the "program service revenue" line say that "unrelated trade or business activities (not including any special fundraising events or activities [which are to be reported on a separate line]) that generate fees for services may also be program service revenue." Similarly, the instructions for reporting "gross sales" say that both related and unrelated sales should be reported together. The instructions for the "other income" line, mysteriously, do not state that any UBI not otherwise reported should be included.
>
> The instructions related to the line for "special fundraising events" define such events as cases (including raffles) in which goods or services "of more than nominal value (compared to the price charged)" are sold for "a payment higher than [their] direct cost." The instructions require that the

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payment be broken down between the value of the goods and service (to be reported as revenue from special fundraising events), with the excess (if any) to be reported as a contribution.

Reportedly, a considerable number of return preparers believe that UBI need not be reported on Part I.

2. Part II, "functional expenses," breaks total expenses into three subcategories, "program services," "management and general," and "fundraising."

None of these subcategories necessarily includes expenses of unrelated business activities. Taxes paid on UBI are, however, stated to be reportable as "other expense," subcategory not stated.

3. Part III, "program services rendered."

The instructions say that the organization is to list each of its program services by "title," identify the service products or outputs, report the "quantity provided," and show "total expenses," including "grants and allocations included in that total." Full information is required only for the four largest program services; other must be listed in an attached schedule. A "program service" is defined as a "major, usually ongoing objective of an organization, such as adoptions, recreation for the elderly, rehabilitation, or publication of journals or newsletters."

4. Part IV, "program service revenue and other revenue (state nature)."

The instructions say the reporting organization is to show here what components enter into the "other revenue" reported in Part I, but, again, they do not indicate whether UBI activities are to be listed. The schedule is required to show gross receipts from each activity.

5. Part VII, line 78, asks if the organization had gross UBI over $1000 and whether it filed a Form 990-T. Only "yes" or "no" answers, without amounts, are required. Question 78 states, "If the organization had income from business activities ... but not reported on Form 990-T, attach a statement explaining your reason for not reporting the income on Form 990-T."

"Gross income" is defined in the instructions as "gross receipts less the cost of goods sold and/or operations." This is the same definition as applies for filing purposes.

In principle, the 78(c) requirement of a statement of reasons "business" activities are not taxable should produce reporting of the basis for treating income as "related," or otherwise not subject to UBIT. Reportedly, very little useful information is obtained, possibly because organizations interpret the reference to "business" activities very narrowly.

6. Part VII, line 80, asks if "the organization is related through common membership, governing bodies, trustees, officers, etc..., to any other exempt or non-exempt organization."

The instructions say that organizations need not report relationships arising only from affiliation with a statewide or nationwide organization, and should disregard "a coincidental overlap of membership with another organization" where membership in the other organization is not a condition of membership in the reporting organization.

This question, which should in theory, identify all controlled subsidiaries, whether taxable or not, reportedly produces little useful information.

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III. Treasury and IRS Proposals. Prior Treasury and IRS Reporting proposals.

1. Treasury's testimony at the June hearings endorsed "obtaining more detailed information concerning the revenues of exempt organizations and the basis for treating them as tax exempt." It did not offer specific suggestions, but proposed an "expanded" Form 990, with "appropriate penalties for failure to file or incomplete reporting." As noted above, penalties for "incomplete" reporting have already been added to the law.

2. The IRS testimony called for "clarification of reporting requirements ... regarding business activity including business activity conducted through taxable subsidiaries" and "simplification" of UBI reporting.

IV. Reporting Proposals in the Discussion Options. The Subcommittee's "Discussion Options" include the following additional reporting requirements:

1. Expanding 990-T reporting on "activities and income which the organization claims to be exempt or excluded from UBIT" and requiring 990-T reporting on "all revenue sources, such as contributions and grants."

2. More detailed reporting on Form 990, the general information return, of "revenue-producing activities and income."

3. A "consolidated information return" for an affiliated group that contains an exempt organization.

4. "Short form" reporting for exempt organizations with revenues below certain levels.

Chairman PICKLE. We thank you, Mr. Ahmann.

We will proceed and ask Mr. Wellford to present his testimony.

STATEMENT OF W. HARRISON WELLFORD, COUNSEL, NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS, GRANTS AND CONTRACTS PROJECT, ACCOMPANIED BY JANNE G. GALLAGHER, COUNSEL

Mr. WELLFORD. Thank you.

I have with me Janne Gallagher. We represent the National Assembly of National Voluntary Health and Social Welfare Organizations, Grants and Contracts Project. These two coalitions represent some 35 national human service organizations. We are in basic agreement with the following options in the draft.

First, to expand the tax information reporting requirements to require more detail on revenue producing activities and income; secondly, to increase the UBIT deduction; third, to apply UBIT to income from certain health and fitness activities unless the program is available to a reasonable cross section of the general public; fourth, to tax royalties measured by net or taxable income; and fifth, to modify the definition of a controlled subsidiary.

We urge the subcommittee, however, to consider the potential adverse consequences of some of the other discussion options. In our April 15 comments, we strongly objected to repeal of the substantially related test and to substitution of a stand alone test for the current fragmentation rule. We continue to believe that repeal of these tests would bring the Internal Revenue Service and the nonprofit community into a lengthy period of confusion and uncertainty without very much corresponding benefit to the small business community.

But even more disturbing is the suggestion that activities should be taxable if they are inherently commercial. Comments of many small businesses make clear that they define commercial as any activities for which there is at least one business provider. To nonprofits, on the other hand, the term "commercial" means an activity carried on for the purpose of making a profit. In other words, for nonprofits, the distinction lies in how, why and to whom the service is provided, not in whether some business has found a way to make a profit by selling the service to the affluent part of the community.

Child care, for example, is offered by government agencies by nonprofits and, increasingly, by for-profit firms. The fact that child care is a pressing community need is widely acknowledged. This Congress, as you know, is devoting substantial time and effort to child care subsidy legislation. If the Business Coalition for Fair Competition suggestion is adopted, that is, adding day care to the list of inherently commercial activities simply because day care services are offered to those who can afford to pay, the logical corollary would be to treat as inherently commercial virtually every nonprofit human service activity from family counseling to nursing homes.

Some business comments suggest restricting nonprofits to serving only the poor whenever services are also available from a business. An immediate consequence of this would be to create two classes of services: one for those who can afford to pay the full cost and one for those who cannot pay at all. Individuals who cannot afford the full cost but can pay something, for example, many lower and middle income families, would fall between the cracks and be deprived of services. Moreover, depriving agencies of the opportunity to use fees from those who can afford the cost of services to subsidize those who cannot would lead to a reduction in services to those who cannot afford the cost.

We agree that nonprofits that are exempt because they serve the entire community must be accessible to the entire community. That is why we support the community accessibility requirement for health and fitness activities.

Mail order and catalog sales of books, periodicals and products are also an important human service activity. From educational materials on alcoholism through talking calculators and watches for the blind, the distribution of these items provides important public benefits. These activities should not be taxed.

Many human service agencies provide medical equipment, devices, laboratory tests and pharmaceuticals, generally at or below cost, as a part of their charitable mission. Goodwill Industries, for example, may sell a $4,000 wheelchair for $2,000 to enable an individual to participate in a vocational rehabilitation program. Some Red Cross chapters offer AIDS testing at a small fee. Surely these activities warrant continued tax exemption.

Travel and transportation is also an important component of many agency services. These trips are not safaries to Kenya or trips to some other exotic pleasure spot, these are trips, for example, such as a local Goodwill using a specially equipped van to transport individuals with disabilities to their jobs or, as a further part of their vocational rehabilitation process, to cultural and recreational destinations on weekends. They are nursing homes chartering a bus to take patients shopping to combat their isolation and loneliness. They are an inner-city group taking kids to a museum on American history or the aerospace museum. The Federal Government specifically encourages nonprofits to provide these services. The subcommittee should preserve the exempt status of these activities.

Finally, certain of the subcommittee's options also could have a significant detrimental effect on nonprofits' ability to raise money through charitable contributions. We urge preservation of the regularly carried on test and the role of the exception for truly passive income.

Thank you, Mr. Chairman.

[The statement of W. Harrison Wellford follows:]

Hearings on the Unrelated Business Income Tax
Ways and Means Committee
U.S. House of Representatives
May 9, 1988

TESTIMONY OF THE NATIONAL ASSEMBLY AND THE GRANTS AND CONTRACTS PROJECT

Submitted by:
W. Harrison Wellford and Janne G. Gallagher
Olwine, Connelly, Chase, O'Donnell & Weyher
1701 Pennsylvania Ave. N.W., Suite 1000
Washington, D.C. 20006
Telephone: 202-775-0200

On behalf of the National Assembly of National Voluntary Health and Social Welfare Organizations and the Grants and Contracts Project, two coalitions of national voluntary human service organizations, we appreciate the opportunity to comment on the subcommittee's discussion options for changes in the unrelated business income tax. We are counsel to both organizations and also authors of the forthcoming National Assembly book, Unfair Competition? The Challenge to Charitable Tax Exemption. The book is the culmination of an exhaustive, year-long review of the historical, political, legal and economic rationales for tax exemption for human service charities.

UNITED WAY SURVEY RESULTS

Before turning to the subcommittee's discussion options, we would like to report the results of a survey by United Way of America of a statistically representative sample of human service agencies which receive United Way funding. This survey, which was stimulated by the subcommitte's hearings last June, confirms three very important facts for the 37,000 nonprofit human service organizations to which United Ways distributes funds.

- Human service nonprofits are not aggressively launching commercial ventures.

Only 7% of the organizations responding to the survey filed Form 990-T. Average gross unrelated income for those organizations was less than 3% of total agency revenue. Only 3% of the organizations had established a for-profit subsidiary.

- Human service agencies are not failing to report taxable income.

Only 1% of the organizations reported an IRS challenge to the exempt status of an activity not reported as taxable. None of these challenges resulted in imposition of tax. 75% of the challenged activities were found to be related and thus not taxable. The rest were determined to be unrelated but exempt from taxation under other provisions of the law.

- Human service agencies are continuing to fulfill their historical mission of making services available to the entire community without regard to ability to pay.

Survey data also showed that about 65% of the agencies charged fees for services or products. 85% of these did so at less than cost or based on ability to pay. 36% of all products and services were offered free of charge. Cost reimbursements from third-parties, such as the government or insurance payments, usually did not cover the full cost of service, requiring the agencies to subsidize the balance through charitable contributions or charges to those able to pay the full cost.

The complete United Way survey is attached to United Way of America's written comments filed in response to the subcommittee's March 31 request.

SUBCOMMITTEE DISCUSSION OPTIONS

Some of the discussion options which are the subject of this morning's hearing are needed and useful modifications to existing law. However, others have far-reaching implications which may be harmful to nonprofit human service agencies.

We are in basic agreement with the following options, four of which were also discussed in the Treasury testimony last June:

- Expand the tax information reporting requirements to require more detail on revenue producing activities and income.
- Increase the UBIT deduction (and the threshhold for filing) with a phaseout beyond $50,000.
- Apply UBIT to income from certain health and fitness activities unless the program is available to a reasonable cross-section of the general public.
- Tax royalties measured by net or taxable income.
- Modify the definition of a controlled subsidiary.

DANGER OF A COMMERCIALITY TEST

In our April 15 comments, we noted a strong objection to repeal of the substantially-related test and to substitution of a "stand-alone" test for the current fragmentation rule. We continue to believe that repeal of these tests would plunge IRS and the nonprofit community into a lengthy period of confusion and uncertainty, as attempts are made to define the parameters of the substitute rule, with little corresponding benefit to the small business community.

Even more disturbing is the suggestion that activities should be taxable if they are "inherently commercial." Comments of many small businesses make clear that they define a "commercial" activity as any activity for which there is at least one business provider. To nonprofits, on the other hand, the term "commercial" means an activity carried on for the primary purpose of making a profit. In other words, to nonprofits the distinction lies in how, why and to whom the service is provided, not in whether there are alternative providers for the part of the community that can afford to pay for it.

This is an important distinction. As we pointed out last June, many of the activities of nonprofit human service organizations have for-profit counterparts. For over four hundred years, the test for whether an activity is charitable has depended on the aims and goals of the organization providing the service and whether the organization's assets are devoted to accomplishing those goals, not on whether a business saw a profit opportunity in providing similar services. The subcommittee should not lightly overturn this precedent.

Child care, for example, is offered by government agencies, nonprofits and, increasingly, by businesses. The fact that child care is a pressing community need is widely acknowledged: this Congress has devoted substantial time and effort to child-care subsidy legislation. Moreover, as the members of this subcommittee are aware, the effectiveness of welfare reform efforts depends to a large extent on the availability and accessibility of child care. Even working parents all too often cannot afford safe reliable child care. Given the magnitude of the [illegible], society should encourage, not discourage, the efforts of child-care providers, many of which are nonprofits.

Yet the Business Coalition for Fair Competition suggests adding day care to the list of "inherently commercial" activities simply because there are businesses offering day care to those who can afford to pay. The logical corollary of this request would be to treat as "inherently commercial" virtually every nonprofit human service activity from family counseling to nursing homes. All have for-profit counterparts.

Some business comments suggest restricting nonprofits to serving only the poor whenever services are also available from a business. An immediate consequence of this would be to create two classes of services: one for those who can afford to pay the full cost and one for those who cannot pay at all. Individuals who cannot afford the full cost, but can pay something, would fall between the cracks and be deprived of services.

Moreover, depriving agencies of the opportunity to use fees from those who can afford the cost of service to subsidize those who cannot would lead to a reduction in services to those who cannot afford the cost. Nonprofit agencies also would lose a significant source of donative income and volunteer services -- more affluent individuals who have received services are often strongly motivated to contribute toward the provision of services to others.

A secondary consequence would be to deprive those who can afford to pay of their freedom to choose a nonprofit provider. Many families may prefer a specific religious or cultural setting for the often intimate and personal services offered by nonprofit human service agencies. Others may prefer a provider which is motivated primarily by generosity and altruism. Still others may wish to choose an organization that has served their community for generations, building a reputation for stability and quality in its services.

Finally, restricting nonprofits to serving the poor would deprive the community of the educational benefits that result from bringing those who can afford to pay into contact with those who cannot. Nonprofits provide a mechanism through which local people can solve local problems by voluntary action. With governance by community-based boards of directors, nonprofits are a focal point in fostering an overall sense of community responsibility for community problems. Depriving nonprofits of their ability to serve the entire community inevitably will weaken the community.

Human service nonprofits have been a catalyst for mobilizing the donations and volunteers that make services available throughout the community at a cost far less than would result from direct government subsidization of services. Depriving nonprofits of their ability to serve the entire community will weaken their ability to continue to mobilize these resources. If private resources diminish, demands for government subsidies inevitably will increase.

SPECIFIC ACTIVITIES

As noted in our April 15 comments, several of the activities enumerated on the subcommittee's list of "inherently commercial" activities are carried on by human service organizations.

Catalog and Off-Premises Sales

Along with many other nonprofits, human service organizations engage in catalog or mail order sales of books, research papers, professional journals, audio-visual materials and other educational material produced in the course of carrying out an organization's exempt purpose. Publication and sale of these materials, most of which have a relatively limited audience, plays an important role in educating the public about human services issues.

Some human service organizations also engage in catalog and other "off-premises" sales of items used in relation to program activities. United Way of America, for example, circulates a catalog to its local affiliates of items, such as pins, placards and other mementos bearing the United Way logo, for use and distribution in local United Way fund-raising. Scout uniforms and accessories often are sold through local clothing outlets or by mail-order through Scout magazines and catalogs. Some nonprofits offer products tailored to the needs of individuals with disabilities, such as talking calculators and watches for the vision-impaired. We urge the subcommittee not to recommend taxing these sales.

Medical Equipment and Devices, Laboratory Testing and Pharmaceutical Drugs and Goods

Some human service organizations make medical equipment and devices available to the public at less than cost, apply a sliding scale fee to measure ability to pay, stretch out payments without charging interest or make equipment available free of charge. Goodwill Industries, for example, may make a wheelchair costing $4,000 available for $2,000 to allow an individual to participate in a vocational rehabilitation program.

Other organizations offer medical testing and health screening programs. Some Jewish human service agencies, for example, may help promote Tay-Sachs screening and some Red Cross chapters offer AIDS tests. There are strong public policy reasons for encouraging the wide availability of these types of health screening activities.

The subcommittee should preserve the exempt status of activities such as these where they are made available to a reasonable cross-section of the community based on the community affordability test outlined for health and fitness activities.

Health and Fitness Activities

We support the community affordability test described in the discussion options as an appropiate limit on the ability of nonprofits to offer health and fitness programs. However, we strongly oppose the suggestion of some interested businesses that program participants be screened for ability to pay and receipts from those above a given income level be taxed.

There are many reasons why organizations are granted tax exempt status. One very important one is to provide services to the poor. However, serving the poor has never been the only rationale for tax exemption for charitable activity. As our discussion of the "inherently commercial" test suggests, legislators and the courts have consistently defined the mission of human service organizations in terms of service to the whole community, the disadvantaged and those who can afford to pay. The reasons for this broad view are clear and compelling.

First, many individuals who are not poor still may be in need of services. Drug abuse is not confined to low-income families, nor is alcoholism or other family problems. YMCA's and similar organizations offer services to families to help prevent these problems from arising and to help alleviate them when they do.

Further, assuring quality services that are responsive to community needs, educating the community in problems it faces, promoting voluntarism and recognizing the important role that nonprofits play in pioneering creative services all are important reasons for tax exemption that go far beyond just serving the poor. We urge the subcommittee to refrain from adopting a means test for access to human service programs.

Travel and Tour Services

As outlined in our April 15 comments, human service organizations offer a wide variety of travel and tour services. One such service is transportation for the elderly, individuals who are disabled, and others needing social services to physicians' offices, congregate meal facilities and similar destinations. Through the Urban Mass Transportation Act, Congress directly encouraged nonprofits to provide these needed services. It would be ironic if Congress were now to impose a tax on their provision.

Many youth organizations, such as the Boy Scouts, the Girl Scouts, Camp Fire, YMCA's and YWCA's, sponsor study trips, field trips and cultural exchange programs as an important part of their activities. Many of these trips are on vehicles chartered from private bus operators. Air and rail tickets typically are purchased through travel agents. We believe that these trips have a minimal impact, if any, on small business revenues and that their tax exempt status should be preserved.

Finally, many organizations arrange trips for the elderly, for persons with disabilities and for others needing social services. The primary purposes of these trips is to forestall isolation by providing group activities and to bring individuals into the mainstream of society. A Goodwill may use its specially equipped van to transport individuals with disabilities to jobs and, on weekends, to recreational activities. A nursing home may charter a bus to take its residents on a trip to a nearby shopping mall. An inner-city youth group may transport kids to a museum on the other side of town.

Payment for the cost of these trips comes from a variety of sources. The Goodwill may be reimbursed for daily transportation to work by the state vocational rehabilitation agency and may subsidize other trips from charitable income. The nursing home may make a small charge and supplement the deficit with funds raised from a benefit dinner. The inner city agency may use money raised by the children themselves through car washes and spaghetti dinners.

Some organizations use their own vehicles. Far more frequently, they charter them. If air or rail travel is involved, travel agents often will be used to procure tickets. The minimal impact of these trips on competition is far outweighed by their value to those served.

Other Activities

We urge the subcommittee to review our written comments, submitted in response to the March 31 request, on adjunct food sales, hotel facilities and routine testing. These activities should be exempt where they are substantially related to an organization's exempt purpose.

FUNDRAISING CONCERNS

Human service nonprofits are concerned that three of the subcommitees's options will have a significant adverse impact on fundraising. These are: i) the suggested repeal of the "regularly carried on" test; ii) the proposal to tax certain types of royalty income; and iii) the proposal to tax all affinity card income.

As our comments discuss, the exemption for activities not regularly carried on provides a relatively clear-cut basis for avoiding taxation of a variety of fund-raising activities that are not competitive in nature. While the volunteer exception doubtless would protect many such activities, the IRS would be forced to examine the ratio of paid staff to volunteers for each event to decide if it should be taxable, a burdensome exercise for activities that are inherently not competitive because of the infrequency with which they are carried on.

We agree with the subcommittee that income from royalties and affinity cards should be taxed to the extent that they represent the active conduct of a business. However, where the income received is passive in nature, taxation is no more appropriate than it would be for income from rents, interest and dividends. Many organizations have benefitted from charitable sales promotions in which corporations make a donation to the charity for each product purchased or coupon redeemed in a given period. Affinity cards are one form of charitable sales promotion. Whether characterized as royalty payments or as charitable contributions, the fact remains that the charity does nothing to earn these payments other than to lend the use of its name and its logo, a traditionally passive activity. We believe the subcommittee should encourage corporations to increase their contributions to charity, not tax the resulting donation.

* * *

Human service organizations traditionally have had strong ties to small businesses in their communities. Without small business support, these agencies would have difficulty raising the funds they need to continue their work. Similarly, without the services offered by human service nonprofits, many small businesses would suffer as their communities fail to address important social problems or do so only through increased taxes. The United Way survey found that few human service agencies had received complaints of unfair competition. We hope that human service nonprofits and small businesses can continue to work together to resolve complaints of unfair competition without the need for a radical reconstruction of the tax code.

Chairman PICKLE. Thank you.
Now Dr. Caspa Harris.

STATEMENT OF CASPA L. HARRIS, JR., EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS, REPRESENTING AMERICAN COUNCIL ON EDUCATION, ACCOMPANIED BY MARY JANE CALAIS, DIRECTOR OF PUBLIC POLICY AND MANAGEMENT PROGRAMS

Mr. HARRIS. Thank you, Mr. Chairman.

For 25 years I have served Howard University as its chief auditor, comptroller, vice president for business and fiscal affairs, treasurer and law professor. I am now the executive vice president of the National Association of College and University Business Officers. This long experience in the higher education community convinces me that colleges and universities seek to comply with the law; that they are prepared to pay taxes as the law fairly determines; and that they are willing to acknowledge errors of judgment where errors have been made. We are willing to acknowledge to the members of this subcommittee that there have been instances of excessive zeal in revenue-generating programs conducted on some of our campuses. What we are concerned about is how this Congress will respond to what I deeply believe to be occasions rather than patterns of abuse.

The subcommittee's discussion options include a number of specific proposals that are reasonable and realistic, and that I believe most colleges and universities would support. The higher education community not only accepts but welcomes the prospect of greater disclosure and enhanced accountability, and, thus, supports enactment of more stringent reporting requirements. We agree that computer sales outside the campus community should be taxed and that the exception for travel services should be limited to travel in connection with academic, scholarly or administrative activities. We accept the proposals to tax adjunct food sales, income from public patronage of hotels, income from affinity card arrangements, and income from certain veterinary services. We support application of the unrelated business income tax to routine testing income, so long as the statute provides a clear basis to distinguish routine testing from testing incident to research.

Although we have no quarrel with these specific measures, however, we very much agree with the position set out in the Treasury's April 15 submission to the subcommittee that problems should be addressed by specific statutory provision, rather than by any umbrella reference to "inherent commercial" activities. We share the Treasury's concern that bringing the concept of commerciality into the statute—particularly with a catch-all category such as the one included in the discussion options—would only invite controversy and confusion. I would also emphasize that because of the complexity of the nonprofit sector, provisions having such broad potential application must be drafted with extreme precision. The proposal for taxation of all "off-premises" sales—which would have such apparently unintended effects as the blanket taxation of university presses and the taxation of books and educational supplies for extension education courses—is a good example of the need for care, and ideally for consultation, in the drafting process.

While agreeing with many of the subcommittee's discussion options, I find myself very troubled by a few. Certain of these proposals would, I believe, change the law in fundamental respects and affect the economies of higher education in very substantial ways.

My first concern involves the proposals for changes to the "substantially related" standard. Again, I find myself in agreement with the Treasury, which indicated in its submission to the subcommittee that such changes would create enormous confusion and disruption for all exempt organizations. The changes would jettison almost 40 years of administrative practice and precedent, leaving organizations without solid basis to judge the financial consequences of their operations. We urge the subcommittee to preserve the "substantially related" standard of present law.

I am equally disturbed by several of the proposals—particularly those relating to cost allocation procedures—that would deny to tax-exempt organizations the benefit of rules and procedures that are otherwise generally applicable. Denying a deduction for overhead expenses or for depreciation, for example, would result in taxation of exempt organizations on more than their true net income. Such rules would subject the unrelated income of colleges and universities to a significantly higher effective tax rate than comparable commercial businesses. This contravenes a basic principle of the unrelated business income tax, that exempt organizations that carry on unrelated activities should be subject to tax on the same basis as the business entities with which they may compete.

As to proposed changes to the royalty exception, I want to emphasize the particular need to preserve current treatment of college and university technology transfers. The importance of technology transfers in enabling businesses to compete effectively in technological development and production has been recognized by the Congress and by a variety of administrative and regulatory agencies. By their nature, such transfers are best accomplished by a sharing of net profits and are thus dependent upon continued application of the royalty exception. Particularly since technology transfers are not the subject of competition complaints—and indeed enhance small business opportunities—we believe that the creation of substantial tax disincentives to such arrangements would be a very serious error.

Finally, I would like to point out to the subcommittee the problems of practicality and predictability that are likely to arise from the proposed repeal of the convenience exception. We have no fear that the operation of dormitories or campus shuttle buses, or laundry services for our students would fail to qualify for exemption under an appropriate legal standard. We are very concerned, however, that without the convenience exception these and many other campus activities would become matters of potential controversy in audits, consuming scarce legal and accounting resources for no apparent purpose. It was precisely to prevent just such unnecessary but predictable problems with IRS enforcement that the convenience exception was originally enacted.

I recognize and appreciate the efforts of the subcommittee and its staff to respond to the needs and concerns of the higher education community. I believe that my comments in these few minutes indicate, however, that substantial issues remain and that continuing deliberation is critical.

I would be happy to answer any questions you may have, and I know that the American Council on Education and the other higher education groups joining in this testimony would be more than willing to participate in your continuing efforts to address this important and difficult problem.

Mr. Rangel [presiding]. Thank you, Dr. Harris. Mr. O'Neil.

STATEMENT OF JOSEPH F. O'NEIL, CHAIRMAN, BUSINESS COALITION FOR FAIR COMPETITION

Mr. O'Neil. Mr. Chairman, my name is Joseph O'Neil, the chairman of the Business Coalition for Fair Competition. I am accompanied today by Mr. Kenton Pattie, who is the vice president of the International Communications Industries Association and a very active member of the steering committee of our coalition.

We represent 30-plus national trade associations and membership organizations whose members, for the most part small businesses, are seriously impacted by commercial activity by nonprofit entities. We applaud the subcommittee for the extensive hearings that have been held and are continued today on this important subject of commercial activity by nonprofit entities.

In general, we support the discussion options that have been presented for our consideration today. We have particular support for one which I will speak about, and then we have certain specific options which we would encourage the subcommittee to strengthen. BCFC supports the repeal of the acknowledged arbitrary and highly subjective substantially related test which was discussed by the recent IRS witness, who I think agreed with our position that the test has failed and continues to be murky and ineffective.

We would recommend, however, the replacement of this test with the directly related test, which has been proposed as a discussion option. This test, the directly related test, we suggest, should be combined with a limited commercial alternative test whereby specific activities, whose nature and scope are inherently commercial rather than charitable, would be subjected to UBIT. Each activity, we contend, should be evaluated on a case-by-case basis. In short, this combination of approaches or tests would provide that activities of the tax-exempt organization should be related directly to its exempt purpose or when the organization chooses to engage in those activities in an inherently commercial manner, those activities will be treated the same as those carried on by a taxpaying small business, that is their fairly determined profits will be taxed. This approach would add the much-needed dimensions of specificity and objectivity to the equation.

What about the list of specific inherently commercial activities identified by the subcommittee? In general, we support these proposals, differing only with some of the well-intentioned exclusionary clauses. Let me cite several of these. The subcommittee, first of all, has presented a discussion option that would apply UBIT to income from gift shops and book stores, except for certain items purchased by bona fide students or health care institution in-patients. We cannot support any exclusion for computer sales to students or faculty even if it is limited to one sale a year. Most students and faculty will purchase a computer only once in their academic career. It is the total of these individual sales, the cost of which is not insignificant, per student or faculty member in the aggregate that would pose an intolerable competitive burden for taxpaying computer retailers. We, therefore, urge all universities and community college sales of computers, computer software and accessories be subject to UBIT.

Regarding the option to apply UBIT to the sales or rental of so-called durable medical equipment and hearing aids, laboratory testing and pharmaceuticals, drugs and goods, BCFC members take strong exception to the exclusions suggested, that is to continuous care and emergency treatment of out-patients and when items are not currently available in the immediate geographic area. We would only support exclusion for sales or rentals to bona fide inpatients.

We strongly support the repeal, not the modification, of the exemption application to organizations testing for the public safety. This work involves commercial, not charitable testing. It was mysteriously exempted by Congress in 1954. We support and, in fact, advocate a further extension of the Treasury Department testimony regarding this exemption. As Treasury points out, this exemption was not explained in the legislative history and has no entirely clear basis for presence in the Tax Code and they recommend, Treasury does, that the exemption granted these organizations be seriously questioned as to whether it continues to be appropriate in its present form. BCFC strongly suggests that it does not.

In conclusion, therefore, Mr. Chairman, in general, we support the discussions options, with these and some other exceptions which time does not permit me to mention.

Thank you.

[The statement of Joseph O'Neil follows:]

STATEMENT OF JOSEPH O'NEIL, CHAIRMAN, BUSINESS COALITION FOR FAIR COMPETITION

Mr. Chairman and Members of the Subcommittee on Oversight, I am Joseph O'Neil, Chairman of the Business Coalition for Fair Competition (BCFC) based here in Washington, D.C. I am delighted to appear before you this morning on behalf of the 30 national trade and membership organizations that comprise BCFC, and their hundreds of thousands of small business, tax-paying members and their employees.

Mr. Chairman, let me be blunt. Small business people all across the U.S. are literally strangling in the grip of unfairly competing, tax-exempt organizations and they need a Heimlich maneuver. The time has long passed for further diagnosis, tests or even second opinions. They need legislative relief now - and that's spelled UBIT reform.

There is no doubt in our minds that we have innumerable small business, tax-paying members out there who have put their life savings into businesses, tried to create jobs and help the community in their own way, who daily experience economic harm from a wide variety of tax-exempt organizations.

You and your colleagues are to be commended for the actions you have taken during the past year - the 5 days of Subcomittee hearings last June, culminating in the list of discussion options for UBIT reform that were issued on March 31st.

Some have said you have gone too far, that you have exceeded your original mandate and intent. We think not. You have made a major step in the right direction, and certainly have gotten the attention of both the small business and tax-exempt organization worlds, as evidenced by the 960 pages of printed comments recently released and the size of this important hearing.

Last June, when I testified on behalf of BCFC, you asked me what types of tax-exempt organizations were engaging in unfair competition, and I indicated that by far the higher education, and health care areas were the largest sources of unfair competitive activity. If one reviews the specific activities you have identified whose nature and scope are inherently commercial, most fall under those two categories. So you have not overstepped your original mandate, at all.

The manifold abuses resulting from unfair competitive activities by tax-exempt organizations, cutting across so many small business endeavors in these and other areas, that were described in multiple detail during the June 1987 hearings, still continue. They cannot be dismissed as episodic, exaggerated or extraordinary, as some leaders of tax-exempt umbrella organizations contend. Nor should your recent option list be described as a complaint list that easily could be expanded by vocal business groups, as one tax-exempt organization recently did.

Mr. Chairman, if we step back from the fray and look at the overall picture, it really comes down to how one phrases the question. If the question is posed as "why are you performing this activity?", it gives rise to a broad response of noble purposes, e.g., "it contributes to the mental, physical and spiritual well-being of people". In other words, in varying degrees, their activities can be related to their purpose. However, if the question is phrased, "what are you doing?" a much different response results - "providing a service or product for a fee, oftentimes in direct commercial, competition with other tax-paying, small business providers". RES IPSA LOQUITUR. The activity speaks for itself. What is taking place is business with all that this encompasses - marketing plans, advertising, utilization of other tax subsidized advantages such as postal rates, and ultimately profits, or net-revenues, which, because of their tax-exempt status, are plowed back into staff salaries and benefits, facility improvements, capital commercial expansion, and also, subsidies to other marginally profitable programs.

Let me, then, briefly react to certain points in the Subcommittee's March 31st Press Release.

The BCFC supports repeal of the acknowledged arbitrary, and highly subjective "substantially related test" and replacement of it with a "directly related test." We would recommend, however, combining the directly related approach with a limited commerciality test, whereby specific activities, whose nature and scope are inherently commercial, rather than charitable, would be subjected to UBIT. Each activity should be evaluated on a case-by-case basis. The reason for this is that a directly related test, standing alone, falls short of identifying those activities which by their very nature are commercial, i.e., standing alone it answers only the first of the questions we referred to before - "why are you doing it" and not "what are you doing."

In short, this combination of approaches or tests would provide that the activities of a tax-exempt organization should be related directly to its exempt purpose, or when the organization chooses to engage in those activities in an inherently commercial manner, those activities will be treated the same as those carried on by taxpaying small business, i.e., their fairly determined profits will be taxed. This approach would add the much needed dimensions of specificity and objectivity to the equation.

Moreover, should these approaches be followed, it would render the "convenience" and "regularly carried on" tests unneccessary. BCFC strongly supports the repeal of these tests. Additional reasons are that convenience can be satisfied by allowing tax-paying business to lease space on the tax-exempt organization's premises, and some business activities, such as audiovisual equipment repair is seasonal in volume.

But what about the list of specific inherently commercial activities identified by the Subcommittee? In general, we support all of these proposals, differing only with some of the well-intentioned exclusionary clauses, that unfortunately do not seem to solve the problem completely.

The Subcommittee, first of all, has presented a discussion option that would apply UBIT to income from gift shops and bookstores, except for certain items purchased by bona-fide students or health care institution inpatients. However, we cannot support any exclusion for computer sales to students or faculty even if it is limited to one sale per year. Most students and faculty will purchase a computer only once in their academic career. It is the multiplicity of sales - the total of those individual sales, the cost of which is not insignificant, per student or faculty member in the aggregate, that would pose an intolerable competitive burden for taxpaying computer retailers.

To put this latter point in perspective, if the income from one computer sale per year to each student and faculty were to be exempt from UBIT, it would enable a 20,000 student body university store to sell up to 20,000 personal or microcomputers a year, at an average sale price of $1,300 for a complete system, thus generating $26 Million in tax-free income annually for the university. Rather than impose a tax responsibility on these university business ventures, it appears that the exclusion proposed in the discussion options would encourage increased computer sales, lead to more aggressive marketing by universities trying to achieve their per-student tax free quota each year and would give an increased competitive advantage to the university store.

Or, viewed from an actual perspective, an 1986-7 survey by the National Association of College Stores reported that 4 and 2 year universities and colleges sold $84 Million worth of computer hardware during the school year, and this figure is admittedly underreported since not all stores participated in the survey. Mr. Chairman, we clearly are dealing with a big business that is not paying taxes under the current rules and almost certainly under the exclusion we are reviewing. We, therefore, urge that all university and community college sales of computers, computer software and accessories be subject to UBIT.

And remember, we have not even cited the immense sales volume of tenuously educational items by museums, zoos, art galleries, and such giants as the Smithsonian Institution and the National Geographic Society. It boggles the mind with the amount of commercial sales that escape, fair and just taxation.

Speaking of boggling the mind, we support the Subcommittee's propcsal to apply UBIT to all catalog, mail/phone order and other "off-premise" sales, since a new imaginative ventures of the higher education community has emerged, namely, the direct-mail catalog marketing of such items as popular videotapes. This involves the use of 800 numbers, and Visa/Master Card/ American Express credit cards. For example, a recent direct-mail catalog from the University of Illinois promotes such "substantially-related, educational" tapes by renowned, "non-faculty" members as Jane Fonda and Jane Powell on aerobic exercise workouts. Mr. Chairman, where will this end, when small businesses already offer the same products and supplies, but pay taxes on their income? For this reason, BCFC would oppose excluding even de minimis sales to this "nationwide student body". Even the Postal Rate Commission has recommended to Congress that nonprofit rates not apply to the catalog sales programs of tax-exempt organizations.

Regarding the option to apply UBIT to the sales or rental of so-called, durable medical equipment and hearing aids, laboratory testing and pharmaceutical drugs and goods, BCFC members take strong exception to the exclusions suggested, i.e., to continuous-care and emergency treatment outpatients and when items are not currently available in the immediate geographic area. We would only support exclusion for sales or rentals to bona-fide inpatients.

While we appreciate the various arguments presented by the tax-exempt healthcare world about wholistic approaches to medical care and the need to constrain costs resulting from inpatient, hospital care, it can be argued that such services are available conveniently and at reasonable, competitive cost from tax-paying providers.

Regarding the sale or rental of hearing aids to outpatients, this would perpetuate the well-documented abuses by tax-exempt hospitals and clinics about which you already have heard. Exempting continuous care outpatients would permit continued abuse by tax-exempt clinics and hospitals, since such hearing health care necessarily requires return visits to the dispenser for various adjustments and battery purchases throughout the life of the device. It is also inconceivable that an emergency treatment outpatient ever would be sold a hearing device.

We would also support excluding income from laboratory testing only of inpatients or emergency room treatment outpatients in connection with their emergency. The same would apply for pharmaceutical drugs, except no refills for former inpatients or emergency room outpatients should be exempt from UBIT. In addition, prescription services provided by Kaiser Permanente or the AARP Pharmacy services should not be characterized as charitable and exempt from UBIT.

You will hear later from one of our member organizations, the Health Industry Distributors Association (HIDA), about their particular concerns about the resales of medical equipment and supplies, purchased originally at below-market prices, for non-hospital institutional or home use, by tax-exempt hospitals, resulting in enormous economic hardship by private, tax-paying distributors.

Finally, any exception about availability in an "immediate geographic area" is frought with definitional problems and can ultimately result in barriers or privileged sanctuaries, precluding future entry by legitimate small businesses.

Regarding the option to apply UBIT to income from certain recreational, fitness, exercise and similar activities, BCFC would strongly oppose the proposed "community affordability" exclusion clause. In effect, this would ratify the current situation or status quo in which upgrade recreation and fitness clubs have been and continue to be built by tax-exempt organizations, such as the YMCAs and non-profit hospitals, exclusively in affluent areas - the executive world of downtown business districts or in trendy suburbs. Thus, a lifetime immunity from taxation would be afforded these highly competitive, commercial endeavors. It is no wonder that in their comment letters the Ys and their tax-exempt allies have welcomed this so-called "exclusion" warmly.

Rather, we would highly recommend a fairer standard that would exempt from UBIT fees received from certain groups of people identified in a series of IRS decisions going back to at least 1973 as truly needy - the unemployed, low-income senior citizens, the military and underprivileged youth. In this way, the commercial, but not the charitable, recreation and fitness activities would be subject to taxation on their net profits.

Of course, to make such an approach workable, tax-exempt organizations would have to utilize strict and fair cost-allocation methods (and not group together, for example, all of the Y locations in a given city in determining overall program costs and net profit). Moreover, they should be precluded from utilizing reserves, derived from previous charitable contributions and bequests, to provide capital for future commercial expansion or developments.

Regarding the proposal to apply UBIT to travel and tour services, the BCFC would only support the exception of those services provided by higher education organizations to their students and faculty as an integral part of or adjunct to a degree related curriculum. The proposal to exclude from UBIT de minimis sales to non-students, or faculty or students apart from their course work would open a proverbial pandora's box and would be unthinkable the larger the extended campus family became. You will hear more about this later in the hearing from one of our member organizations, the American Society of Travel Agents (ASTA). However, it seem quite fair to limit the tax-exempt organization's role to selecting and endorsing travel and tour services, without remunerative return and without giving their other exempt benefits to the firm selected, such as advantageous postal rates, free public service advertising, and free on-site office space.

The proposal to apply UBIT to income from certain veterinary services such as grooming, boarding and all elective surgery should be expanded. The only exceptions to UBIT coverage should be for services performed on stray animals, animals owned by indigent people and those services performed by teaching institutions to provide clinical education for their students. For all other veterinary services, especially spaying and neutering, measures to protect public health (whatever that may mean) and veterinarian recommended procedures, there are ample, tax-paying small business providers who are as qualified as humane societies. In fact, it is reported that approximately 93 percent of for profit veterinary service involves spaying and neutering.

BCFC also supports the application of UBIT to routine testing income, but without exceptions. We do wonder, however, why several inappropriate and anachronistic, blanket exceptions for reseach have not also been recommended for deletion, namely, (1) the exemption of all research by tax-exempts for federal, state, or local governments, (2) the exemption of research for any client by a college, university, or hospital; and (3) the exemption of research for any person by an organization operated primarily for carrying on fundamental research, the results of which are freely available to the general public?

Moreover, we strongly support the repeal, not the modification, of the exemption applicable to organizations "testing for the public safety" since this justifiably involves commercial, not charitable, testing which was mysteriously exempted by Congress in 1954 and favored the quasi-monopolistic Underwriters Laboratories without any accompanying explanation.

Among additional specified activities determined to be inherently commercial, we would strongly suggest supplying UBIT to all income from child care services provided by tax-exempt organizations, except for fees coming from unemployed parents or guardians, and low-income senior citizens. As the nation evolves more and more into a situation where child care becomes the norm, on can expect an even greater expansion in that lucrative market on the part of tax-exempt entities, such as the YMCA.

Other activities that should fall into this catch-all, inherently commercial category are the provision of laundry and answering services to non-employees by tax-exempt hospitals, the renting out of audiovisual equipment by tax-exempts for meetings outside their organizations, the commercial rental use of hospital, medi-vac helicopters, and the many and diversified high volume program activities of such tax-exempt giants as the Smithsonian Institution, the National Geographic Society, and the AARP (which according to a recent Washington Post article provides or endorses so many services, that it reaps a reported $19 million annual profit alone on the "float" from health insurance premiums received).

With reference to the additional items referenced in the March 31st Press Release, BCFC would offer the following brief observations. We support the Subcommittee option regarding royalties received by tax-exempts since many obtain profits in the form of royalties, and thus screen their income from UBIT. A few years ago, for example, the National Education Association set up a for-profit organization to sell computer software. The for-profit was to provide net profits to NEA in the form of royalties which was then to be placed in one of the NEA's charitable funds. Since the company was operating on a license from the NEA to use the NEA endoresment, the company had the NEA "halo", direct access to NEA members, and from our perspective was operating as an arm of NEA.

BCFC would caution also, that an exception for products that are part of the organization's exempt function could lead to abuses, such as the sale of athletic equipment, shoes, clothing with official logos, etc., as a lucrative type of partnership or mutual business venture which has nothing to do with the organization's stated mission, and is only another aspect of competitive trade or commerce.

BCFC would agree with the suggestion that the existing UBIT deduction for certain Section 501(C) organization be increased from $1,000 to $5,000, provided a phase-out beyond the $50,000 income level is stipulated. Limiting the increased deduction to those activities directly carried on by the exempt organization would be prudent.

Regarding the proposed changes in the treatment of subsidiaries and joint ventures, BCFC supports a modification and extension of the definition of "control" of taxable subsidiaries to mean ownership directly, indirectly, or by attribution of at least 50 percent of stock by vote or value in the aggregate. The proposal that aggregates income and activities of subsidiaries to determine if the primary purpose of the non-profit parent is in fact a tax-exempt purpose is strongly endorsed by BCFC. Further, BCFC would be in favor of requiring that no more than a stipulated portion of a tax-exempt organization revenues for a special period be derived from taxable subsidiaries and/or joint ventures.

The proposal relating to allocation rules, in the view of BCFC, would be strengthened by disallowing eligibility or any deduction if facilities are utilized for both exempt and non-exempt activities. If this suggestion was found impossible, BCFC would favor the discussion option released by the Subcommittee.

BCFC strongly favors the information reporting proposals, in particular the one expanding the 990-T form to include more reporting on activities and income which the organization claims to be exempt or excluded from UBIT. This would mean that all revenues associated with support for a non-exempt, commercial activity, including gifts, donations and investments income, should be disclosed, thus subscribing to the accpeted accounting principle of matching actual revenues to actual costs. In a similar vein, BCFC supports more detailed reporting of all revenue-producing activities and income on the 990 essential to the program, especially the recommendation that the IRS (or GAO) undertake a comprehensive review of the multi-layered, corporate reorganizations that have taken place in the tax-exempt world, and the impact that "for-profit" subsidiaries of charitable organizations may have, related to competition with small business.

The BCFC, finally, strongly endorses the proposal of the Small Business Administration (SBA) that the IRS institute an expedited, administrative channel for the filing and review of complaints about commercial, competitive activities of tax-exempt organizations. The protective spirit of UBIT and the administrative efficiency of the IRS can be better served if the IRS has access to information targeting potential compliance with the law. It is tax-paying, small business which are in the best position to identify potential violations of the law, but currently have no formal, nor cost-effective mechanism to do so.

Mr. Chairman, the hearing today represents another major stride in the effort to provide a more level competitive field. BCFC commends you and your colleagues for your efforts to arrive at a just and equitable solution to the pervasive problem of unfair competition. No member organization of BCFC is demanding that any legitimately-exempt organization be stripped of its IRS designation. These tax-exempt organizations still would enjoy a wide array of exempt advantages, such as property tax exemptions, advantageous mailing rates, "captive referrals," etc. All we ask is that when inherently commercial, competitive activity has been undertaken by a tax-exempt entity, it be willing to pay some fair tax on its profits.

We applaud your efforts to restore and preserve the original intent of UBIT when it was introduced 38 years ago to safeguard small business endeavors from the unfair competitive advantages enjoyed by tax-exempt organizations. Please give us that Heimlich maneuver of targeted UBIT reform soon. Thank you.

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Mr. RANGEL. Thank you, Mr. O'Neil.

Now we will hear from Mr. Smith from the Small Business Legislative Council.

STATEMENT OF WAYNE J. SMITH, CHAIRMAN, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SMITH. Thank you, Mr. Chairman.

I am glad the chairman has returned. I would like to introduce myself with three hats I am wearing today. One is the chairman of the Small Business Legislative Council. Two is the executive director of the United Bus Owners of America, and third I serve on Mr. O'Neil's steering committee of the BCFC.

We again want to compliment the subcommittee on its work. We also want to, Mr. Rangel and Mr. Chairman, before you leave, we would like to compliment the staff for all of the extra time that they have put into studying this issue. Everybody has complimented the subcommittee, Mr. Chairman, but before you left, I wanted you to know we recognize that the staff spent a lot of time on this and should be commended for their excellent in its work on this matter.

We support all of the options that have been produced so far by the subcommittee and also in my role as the executive director of the United Bus Owners, I would like to clarify something that Mr. Wellford said in his testimony about the travel and tour options, Mr. Chairman. In the social welfare area, HHS gives $1.2 billion to take care of our handicapped and disadvantaged people in the United States, $1.2 billion. I cannot see—and we brought this up in our testimony in June—why these organizations are using that equipment to take people to Atlantic City, to Disneyland, Disney World and other amusement parks and charging on a per capita basis in competition with our bus owners. Again, that is why I think your option on travel and tour activities is very very good.

Also, much just a couple weeks ago, on the university side of the transportation issue, when we took the options to a major university in the State of Virginia, just your options, and told them this is what the Ways and Means Committee was thinking about, they stopped using the buses that they were using for their internal use to occasionally take students on a per capita basis to amusement parks and to other places. So maybe the direction that you are taking, even if it is in an option form, is starting to get down to those people that are affected.

Also has been written about who the players are in this issue. The issue of unfair competition is not directed at trade associations as has been written about lately in the last few months in major publications. Trade associations are not unfairly competing with small business, although trade associations and other nonprofits are governed by the same rules. An examination of the testimony before the Committee on Ways and Means reveals the true nature of activities which result in unfair competition. These activities include laboratory testing, travel services, laundry, hearing aids, medical sales and other services and the most frequently mentioned competitors were universities and hospitals. These entities are not associations. However, through activities like those outlined above, they have become small businesses under the nonprofit heading.

Last, a small businessman wrote this in a letter to me last week when he knew that I was going to testify. He said—I would like to use this as a conclusion to my statement, Mr. Chairman—that it was Teddy Roosevelt who said the role of government is not to make certain everyone is dealt an equal hand, only to assure that the deck isn't stacked.

Thank you, Mr. Chairman.

[The statement of Wayne J. Smith follows:]

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STATEMENT OF WAYNE J. SMITH, CHAIRMAN, SMALL BUSINESS LEGISLATIVE COUNCIL

My name is Wayne J. Smith and I am the Chairman of the Board of Directors of the Small Business Legislative Council. The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached. On behalf of SBLC, I would like to make the following observations.

First, we wish to commend the Chairman and the subcommittee for the time and effort that the subcommittee has devoted to its review of the Unrelated Business Income Tax. The record of last June's hearings and the subcommittee options' paper will stand as excellent resources for the future, regardless of the outcome of this immediate discussion. If one observation can be made about this subject matter, it is that it has grown in complexity over the years. The committee staff has done yeoman like work in sorting out the many facets of this problem.

The purpose of today's hearings, as we understand it, is to focus on the solutions rather than rehashing the problems. We believe that small business has established, beyond a shadow of a doubt, that there is a problem of unfair competition by nonprofits with small businesses.

On the whole, we are pleased with the options formulated by the subcommittee. In Section one of the options' paper, the subcommittee has enumerated 11 specific activities that are inherently commercial in nature. From our experience, and I will address this further in my testimony, these activities do represent the substantial "bulk" of unfair competition. In fairness, however, I must say we can make a good thing even better. Several SBLC member organizations, that represent industries directly affected by one of the specific recommendations, have submitted comments on how to improve these 11 recommendations. Enactment of the recommendations with these further suggestions would result in the effective end of unfair competition.

These recommendations, however, must be augmented by a mechanism that will allow for future concerns. As an advocate for all small businesses, we believe the legislation must include strong language to permit a swift and definitive determination of whether activities, not included among the 11 enumerated activities, are inherently commercial in nature. The service sector is the fast growing segment of our economy. Small businesses are constantly opening new markets and nonprofits are constantly seeking to develop new revenue sources. As a result, the law must provide the necessary flexibility to encompass future endeavors.

We are pleased that the subcommittee has chosen to identify several administrative reforms. We believe all parties agree that better information collection and enforcement is appropriate. We do not believe, however, that other reforms should be delayed. These administrative reforms should be enacted concurrent with other initiatives.

Much has been written and said about the "players" in this issue. The issue of unfair competition is not directed at trade associations. Trade associations are not unfairly competing with small business. Although trade associations and other nonprofits are governed by the same rules, an examination of the testimony before the Committee on Ways and Means reveals the true nature of activities which result in unfair competition. These activities include laboratory testing, travel services, laundries, hearing aid and medical sales, veterinary services, and physical fitness and recreation services. The most frequently mentioned competitors were universities and hospitals. These entities are not associations. However, through activities like those outlined above, they have become small businesses under the "nonprofit" heading.

Several factors make unfair competition by nonprofits a serious problem for small business. Foremost among these is the fact that small businesses dominate the service sector. At the same time, the nonprofit community is best-suited for expansion into service markets. Universities, hospitals, and other nonprofits have both the facilities and the personnel. It is only a matter of applying a little creative planning to develop new markets for nonprofits. The reasons for their expansion into traditionally for-profit areas are obvious--declining revenues, increased costs, and excess capacity.

Because of this, it's hard to fault the nonprofits; any small business would be expected to apply the same strategies under those circumstances. But nonprofits apply this strategy without the tax accountability of small business.

Another factor contributing to nonprofits' disproportionate impact on small business is the fact that the competition takes place in local markets. Professional and technical services do not lend themselves to national marketing strategies. Thus, competition generally pits one nonprofit against one local segment of the for-profit community. We hope the subcommittee will keep sight of the primary sources of unfair competition as you consider the options.

Finally, we must remember that the issue is unfair competition. If an activity is netting millions of dollars for a nonprofit, we do not believe the responsibility to pay taxes will mean the end of the nonprofit's participation in the activity. The consequences of subcommittee adoption of the options are not the end of nonprofits, but the establishment of an appropriate balance between the responsibilities and roles of for-profit small businesses and nonprofits in our economy and society. We believe such a goal is a worthwhile one, and the options before the subcommittee will accomplish the task. Thank you for this opportunity to testify. I will be pleased to answer any questions you may have.

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United Bus Owners of America

1025 Vermont Avenue, NW/Suite 1201/Washington, D.C. 20005/(202) 639-8500

Small
Business
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April 14, 1988

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

On behalf of the Small Business Legislative Council (SBLC), I wish to submit the following comments regarding options, developed by the Subcommittee on Oversight, to revise the unrelated business income tax. The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

SBLC hopes the subcommittee will move swiftly to stem the tide of unfair competition by nonprofit entities. We believe that small business has established, beyond a shadow of a doubt, that there indeed is a problem that demands solutions. The record from last year's hearing demonstrate that fact conclusively. The options developed by the subcommittee address the breadth and depth of the problem. The subcommittee and its staff are to be commended for their efforts.

In Section I Substantially Related Test, the subcommittee has enumerated eleven specific activities that are inherently commercial in nature. From our experience, these activities do represent the substantial bulk of unfair competition, as the hearings last year revealed. I am sure some of SBLC's member organizations will offer suggestions to improve these recommendations to ensure the development of a truly level playing field. From our perspective, adoption of the specific recommendations would result in the effective end of unfair competition.

However, as an advocate for all small businesses, we believe the legislation must include strong language to permit a swift and definitive determination of whether activities, not included among the 11 enumerated activities, are inherently commercial in nature. The service sector is the fast growing segment of our economy. Small businesses are constantly opening new markets and nonprofits are constantly seeking to develop new revenue sources. As a result, the law must provide the necessary flexibility to encompass future endeavors.

We have long advocated a reversal of the current presumption that has evolved in the courts in favor of the nonprofits. Nearly any activity can meet the substantially related test as it now stands. We believe it is incumbent upon the nonprofit to demonstrate that the activity it is about to undertake is consistent with its basic charter and the objectives upon which our tax code grants favored status for tax-exempt organizations.

The reason the unrelated business income tax is ineffective is that it relies on determinations of motive in the already gray area of relatedness. It is a gray area because nine time out of ten, expansion is going to be built on existing resources and talents and thus will, in the commonly accepted sense, almost always be related. The macaroni factory cases are the exceptions rather than the rule. The presumption in current law and enforcement is that the purposes comes first, and the nature of the activity second. The Presbyterian & Reformed Publishing case (79 TC 1070 (1982), rev'd 743 F.2d 148 (1984)) illustrates this most graphically.

The solution is to reverse the logic. First, let us identify what are the commercial activities and then permit the nonprofit to demonstrate circumstances which would warrant continued performance of the activity. If an activity resembles a commercial activity it should be taxed like one. If the tax-exempt organization chooses to pay the tax then it should be permitted to carry on the function. Our objective is fair competition, not the elimination of competition. We recognize the need for some flexibility and would make the test a rebuttable presumption. The nonprofit could then demonstrate the need for its commercial services in the community. Therefore, from our perspective, the recommendations under Section I address the heart of the issue.

It is not our position to comment on recommendations II through VIII since these recommendations address the manner in which nonprofits execute their responsibilities rather than the nature of the business. While many of these reforms may be worthwhile, as representatives of small business our principal concern must remain with their inherently commercial activities. We hope the subcommittee will endorse those recommendations in Section II through VIII that will achieve a level playing field.

We are pleased that the subcommittee has chosen to identify several administrative reforms. We believe all parities agree that better information collection and enforcement is appropriate. We do not believe, however, that other reforms should be delayed. These administrative reforms should be enacted concurrent with other initiatives.

Finally, much has been written and said about the "players" in this issue. We wish to share with the subcommittee a recent editorial written by the SBLC Chairman. The attached editorial appeared in the Executive Update of the Greater Washington Society of Association Executives. We believe it summarizes our views on this important subject.

In conclusion, we are greatly hearten by the subcommittee's work and look forward to working with you to solve the problem of unfair competition.

Sincerely,

John S. Satagaj
President

JSS/0475
Enclosure

COMMENT

Wayne Smith

Why unfair competition is exactly that

Recently, much has been written about the hearings held last June by the Committee on Ways and Means. The subject of the hearings was the unrelated business income tax (UBIT). The small business community has charged that nonprofits are engaging in unfair competition with the for-profit sector. I would like to dispel the belief that this is a small business versus association issue. This is simply not true.

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of over 90 associations. One of the most important facts about SBLC is that it is managed and directed by senior-level association executives. It represents a diverse range of interests from manufacturing to transportation and all areas in between. It therefore has a stake in both the association and small business worlds.

The prime objective of the SBLC is to assist association executives in responding to pertinent legislative issues. The SBLC is constantly alert to legislative matters and its goal is to deliver cost-effective and timely service to SBLC members.

The issue of unfair competition is not directed at trade associations. Trade associations are not unfairly competing with small business. Although trade associations and other nonprofits are governed by the same rules, an examination of the testimony before the Committee on Ways and Means reveals the true nature of activities which are unfair competition. These activities include laboratory testing, travel services, laundries, hearing aid and medical sales, veterinary services, and physical fitness and recreation services.

While entities such as the National Geographic Society and the YMCA were mentioned as competitors, the most frequently mentioned competitors were universities and hospitals. These entities are not associations. However, through activities like those outlined above, they have become small businesses under the "nonprofit" heading.

Several factors make unfair competition by nonprofits a serious problem for small business. Foremost among these is the fact that small businesses dominate the service sector. Ease of entry, low capital costs, and abundant human resources make the service industries ideal spawning grounds for small businesses. The expanding role of small business in the service sector coincides with the measurable movement of our economy towards a service-based economy. When all is said and done, small business *is* the service sector.

At the same time, the nonprofit community is best-suited for expansion into service markets. Universities, hospitals, and other nonprofits have both the facilities and the personnel. It is only a matter of applying a little creative planning to develop new markets for nonprofits. The reasons for their expansion into traditionally for-profit areas are obvious—declining revenues, increased costs, and excess capacity. Because of this, it's hard to fault the nonprofits; any small business would be expected to apply the same strategies under those circumstances. But nonprofits apply this strategy without the tax accountability of small business.

Another factor contributing to nonprofits' disproportionate impact on small business is the fact that the competition takes place in local markets. Professional and technical services do not lend themselves to national marketing strategies. Thus, competition generally pits one nonprofit against one local segment of the for-profit community.

The problem is that we have a nonprofit sector which is turning a considerable "profit" at the expense of the taxpayer and small business. At one time charitable entities had clear purposes and equally clear means of support. Now many have become growth industries which, for all intent and purpose, are unregulated.

Unfair competition arises from the fact that these nonprofit organizations may use their governmental exemptions or privileges to offer services at a lower price, to subsidize market entry, or to use the aura of the government imprimatur to win marketshares. This competition takes place within a marketplace of commercial activity; far from the typical programs of most associations.

We view the hearings of the Committee on Ways and Means as a positive step. First, it is to the benefit of our economy and job market to ensure that every association's business members have the opportunity to compete fairly. Second, it is an opportunity for the association community to clearly define the positive contributions made to our society through and by associations. ☐

Wayne Smith is the executive director of United Bus Owners of America. He is also chairman of the Small Business Legislative Council.

Mr. Rangel. Mr. Schulze.

Mr. Schulze. Thank you, Mr. Chairman. Mr. Chairman, I just want to thank this panel for their testimony. I don't have any specific questions. One of the reasons for the hearing today was to give everyone the opportunity to present their views both verbally and in written form. This panel has done that and done it very well. We appreciate the input, and we want you to know that we will continue to enjoy having that kind of input as time goes along.

Unless somebody has something they would like to add, I have no specific questions.

Mr. Rangel. I would like to join with Mr. Schulze for the fairness in which this panel has addressed this very complex situation and in pointing out those areas of abuse that you honestly believe should be corrected, and also the problems that could be presented if we overstate the legislative case.

Mr. Pickle.

Chairman Pickle. Mr. Chairman, I thank you.

I thank you individuals and organizations for appearing here today. I want to assure you, although you are being limited in your testimony, we have your entire testimony, and we will examine it and study it because your views are important to us.

We have got a cross section group here, but we are trying to find an approach that would, as Mr. Smith said, give us a fair playing field. I think we can do that.

I asked some of the panel earlier this morning, do you think we can reach an accord? Naturally we must because while we do not want to see these organizations expand to the point where it would be unfair to private business, we also recognize, and I am sure a lot of you do, these tax-exempt organizations serve a very definite good public purpose. We don't want to stop them from performing those activities, because if we did it, we would be doing it at a higher cost and probably less efficiency.

At the same time, we must recognize that which is the substantially related test has got to be adhered to. I think that is what most of you are recommending. Some of you—the first two people I think testified, and I didn't get to hear all the testimony, whether you were concerned mostly about the phrase "inherently commercial". Do you recommend some kind of an alternative to that? Would you rather just keep "substantially related" or mainly just stay away from the "commercially"? Mr. Ahmann.

Mr. Ahmann. We consistently recommended we stay with the relatedness test and not deal with abuses in a way that would suggest another theory, down the line, for the courts to grapple with. We prefer keeping the substantially related test, the 200 court cases, revenue rulings and other things which have been issued under it.

Chairman Pickle. Does anybody else on this panel disagree with the position that we probably should keep the related test? Mr. O'Neil.

Mr. O'Neil. Speaking for BCFC, Mr. Chairman, we strongly disagree with that position. We feel, I think, what IRS testified just recently, that they are losing ground continually, in trying to apply this test, bears out what our position has been from the start, which is that a new test is needed because this one is not working.

As Mr. Swain pointed out, the courts in interpreting it are all over the lot. It is a very ambiguous test, admits a lot of subjectivity in application, and simply isn't workable in its present form. So we propose an entirely different test that would base itself on the inherently commercial test as being the relevant one here.

Chairman PICKLE. Dr. Harris, you were trying to comment.

Mr. HARRIS. I go back to what the Treasury has said this morning, Mr. Chapoton. He has indicated, and I support what he has said, that substituting this test for substantially related is just a play on words. It doesn't seem to strengthen it at all. Even though there have been over 200 court cases, we have a multitude of regulations, but we have almost 40 years worth of experience.

Now, Mr. Chairman, if we are going to throw that out and start out with a directly related test, I submit to you we are going to go for another long period of trying to interpret what this means. I am not sure anyone knows, and, from my perspective, understands what impact directly related is going to have as we look at this.

Chairman PICKLE. Mr. Smith.

Mr. SMITH. Just briefly, Mr. Chairman, I think what has happened is that 40 years ago this problem was not as acute as it is today, or we wouldn't have had the hearings a year ago. We are changing the way we work, the way we play, the way we operate government today.

A case in point, Mr. Wellford talked about the UMTA rules and regulations. It took the bus industry 10 years after UMTA first said to the mass transit authorities, "Do not abuse the charter rules and regulations. Do it the proper way" to change the situation. But after 10 years of abuse, the Urban Mass Transit Administration finally had to put out rules and regulations to tell the mass transit authorities to stop doing charter work.

So, again, I think what we need to do is get these clarifications before the people who can enforce them, and that is the IRS, and they asked and pleaded for your help this morning.

Chairman PICKLE. Looks like our harmony is in question right now, doesn't it? That is all right.

Now, do any of you organizations use affinity cards? That is not a problem with your organizations, is it?

Mr. AHMANN. I am with Catholic Charities USA. We don't presently have an affinity card, but we have just entered into a contract to have an affinity card.

Chairman PICKLE. Can any of you—none of you really use it. I was going to ask how could you consider an affinity card as conducted in furtherance of the exempt purposes? It would be rather difficult, wouldn't it?

Mr. AHMANN. I can't speak for any organization but my own on the question of affinity cards, and our organization is prepared to pay UBIT.

Mr. HARRIS. The same is true, Mr. Chairman, for colleges and universities. They are prepared to have these items subjected to UBIT.

Chairman PICKLE. We listed as our discussion options in the first option, Mr. Secretary, Mr. Chapoton commented on it today, about 12 different categories, from "A" to what we call "L" or whatever. I imagine you all heard the testimony and are familiar with it.

Of those recommendations, which one of them seems to bother you the most? Any one in particular? Dr. Harris.

Mr. **Harris**. The one that seems to bother us a great deal is the allocation rules. We heard testimony this morning from the various small business groups, and, of course, from the General Counsel for the Small Business Administration, that they want fair competition. He did not say and no one else has advocated they want no competition.

I don't understand why the Internal Revenue Service cannot deal with the allocation rules for both depreciation and indirect costs. We have principles set out for that under general accepted accounting principles that should apply to higher education like they apply to the for-profit sector.

Chairman **Pickle**. I don't think the Treasury said that they didn't want or would not apply by the allocation rules. They had some different viewpoints on the approach. Am I correct?

Mr. **Harris**. I think the IRS said there were great difficulties in the allocation of indirect cost and depreciation. What I would suggest is we use the same rules as we do for the private sector. Higher education has never objected to using the same rules, but we do object to the fact that we throw out indirect costs and we throw out depreciation, which are recognized expenses. That puts us at a major disadvantage, and we are paying a higher proportion of taxes than the for-other business sector would.

Chairman **Pickle**. All right. Mr. Ahmann.

Mr. **Ahmann**. Mr. Chairman, dealing with the issues really depends on how you draft them. It is very difficult to know what they mean. For example, off premise sales, the Catholic Bishops throughout the United States and throughout the U.S. Catholic Conference here have a substantial public program communicating and teaching on moral and social issues. They do not have a book store. Their sales are entirely off premise by catalog, by phone, et cetera. So I presume that under one version of drafting this, you would catch that kind of activity, though that is probably not what you meant.

Yet when I raised that specific example with a member of the subcommittee, he said immediately it should be in a taxable subsidiary. So we certainly are confused as to what some of these mean, and it is very difficult to know how to respond.

Chairman **Pickle**. All right. I think your observation is reasonable. This committee is not trying to make up its mind now. We are trying to analyze what seems to be fair, what is a better approach. But I think generally speaking, we all agree it is better that we have a more clear understanding about reporting, a better understanding of what is expected, when exempt organizations are supposed to make these filings and the Government expects the returns to be submitted.

I think the sooner all organizations recognize that, the better off we are going to be. I don't want to just keep repeating, but when we first started these hearings a year ago, we were told by some of the organizations that they just didn't really remember how they handled their reporting requirements, that they forgot how that was being administered by their organization, and one even said they didn't think how their organization handled reporting was any of our business; it was of a confidential nature.

Well, that cannot be accepted by this committee. Now we are getting better information. I think we are all understanding better how we go about this. I hope we can continue on that basis.

Mr. O'NEIL. Mr. Chairman, may I take advantage of your invitation to comment on your "A" to "L" options? There is one point I meant to make in my testimony regarding the option to apply UBIT to income from certain recreational, fitness and similar activities. I did want to mention the BCFC would strongly oppose the proposed community affordability exclusion clause and recommend instead a substitution of a test which would apply the exemption only for activities serving the truly needy, that is the unemployed, low income, senior citizens, the military and underprivileged youth.

This way we feel the commercial but not the charitable recreation and fitness activities would be subject to taxation on the net profits.

Chairman PICKLE. I am glad to have your observation on that point too. As far as I am concerned, I thank you for your testimony. You have different views, but you can see all the Congress is trying to establish at this time is a good basic approach to what we are analyzing. An approach we can live with, and I think we must find a better answer. So we will continue to look at these issues. Dr. Harris.

Mr. HARRIS. Mr. Chairman, just one last thing. On the royalty exclusions that you have as an option, we would urge the subcommittee to preserve the technology transfers. This is a national problem whereby colleges and universities may come up with something new that is applicable, that is not commercially feasible at this stage. The institutions simply generally do not have the money or the time or necessarily the expertise to make the new product available for commercial use.

What we have done in the past is to work with businesses. We would turn this over through patents or licensing, or what have you, and we would work with both large and small businesses. From those products that become commercially feasible, colleges receive a percentage of royalty fees from the sales. Historically, what has happened in the past is the royalty fees that we receive, a portion is allocated to the principal investigator who, of course, pays taxes on it. The remaining portion goes back to the institution, either to the school or to the individual's department, and these funds are used for further research, and, in some instances for educational purposes.

We feel it would really be a disservice to tax that type of royalty income. We would encourage you not to do so. We certainly have been in a partnership with business in this regard, and what I am afraid of, if we have taxation in this area, it would certainly discourage many new products from ever coming to the commercial world.

Thank you, Mr. Chairman.

Chairman PICKLE. I don't know that I am prepared to comment on your specific feelings. Obviously, a royalty payment is income. To the extent it is not substantially related, we have to take that into consideration. I don't see why you would object, since that is part of your exempt function, why you would object if you would pay just on unrelated business income. We are not prohibiting you from receiving royalties. We just said if that happens, some of it would be considered as unrelated business income. You object to that?

Mr. HARRIS. No, sir. What we object to is that our portion of it is considered research, and we don't feel that that should be taxed.

Chairman PICKLE. I understand that. OK.

Mr. HARRIS. The other part we have no problem with it.

Chairman PICKLE. Thank you, Mr. Chairman.

Mr. RANGEL. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

Mr. Wellford, sort of as an aside, when you were talking about travel in your testimony, you said these kinds of activities are not trips or safaris to Egypt or Africa, or something like that. What if they were not in furtherance of the educational experience or research or anything else but strictly for fundraising purposes? Would you object to paying a UBIT on something like that?

Mr. WELLFORD. If our human service organizations were engaging in that kind of activity, I think I would expect them to pay UBIT.

Mr. McGRATH. Dr. Harris, we have been hearing, I suspect, from some colleges and universities, basically state colleges and universities, that they object to even the filing of a 990-T based on some constitutional problem. Is it the understanding of your organization that that is a problem? And, if so, what are the constitutional constraints here?

Mr. HARRIS. I don't know what the constitutional constraints are. Our organization is looking into this. We have heard some complaints as well. One of the things that we are going to do with the National Association of College and University Business Officers, we are going to hold workshops on this. I have not seen any court cases prohibiting any state institution from the filing, even though some state institutions have raised the issue. I don't know the specifics and I cannot provide an answer except to tell you that we are going to do more with our association to try to get everyone who is supposed to file to file.

Mr. McGRATH. One question regarding the royalties issue. It is very technical, and it is very complex. But let's say the grant under which a college does research is a Government grant and because of the research gets some sort of patent, or even perhaps the grant was made to some commercial group that gave the research or contracted it out to some college.

Now, in that particular case, the commercial enterprise probably would get a tax deduction for giving the college the money to conduct the research. Then at the same time at the other end of the stick, that perhaps because a patent was secured on the research results and then a royalty paid back to the original college doing the research, that the overall result is that we sort of lose on both ends of the spectrum in terms of the revenue impact here.

How do we reconcile that?

Mr. HARRIS. First with the Federal Government, the Government's rules and regulations themselves encourage institutions, when they receive income from these sources, to use that income for further research or for educational purposes. If a not-for-profit organization contributes funds to an educational institution for a research proposal and out of that work there is a patentable item, and assuming, of course, the institution can receive all of the income from that patent, that income generally goes to the institution to further its educational research efforts.

Quite frankly, there is very little money available for research in higher education when you look at the whole thing, and from the commercial side, if you took it all together, educational institutions receive only approximately 15 to 20 percent of research funding from this source.

Mr. McGrath. Is there any requirement that all of the royalties from these commercialized patents go back into research, or is this some determination made by the individual institution?

Mr. Harris. Generally, the conditions are determined by the donor. If the funding is from Government funds, the requirements are set forth in Government regulations. Or if the grant is from a private donor, the donor and the institution would normally work those terms out prior to the discovery of anything that is patentable.

Mr. McGrath. There is nothing in the IRS regulations?

Mr. Harris. Not that I know of. The only thing under the current law is that these technology transfers are not taxable. I don't think they have been the subject of the small business coalition request of unfair competition in this area. We are asking that whatever you do on this, that we don't tax the research portion of royalties.

Mr. McGrath. Thank you.

Mr. Chairman.

Mr. Rangel [presiding]. The Chairman asked me to thank this panel for its cooperation and to ask you to continue to share with us the results of your work in this area. Especially Dr. Harris, who in addition to indicating your concerns, has promised to ask for more voluntary compliance, because things that are working we certainly don't want to interfere with.

But we ask all of you to take advantage of Mr. Smith's recognition of our fine staff and to share your opinions with us.

Thank you.

The next panel is the National Association of College Stores, Paul Mares; the American Arts Alliance, Peter Marzio; the Association of Business Publishers, John Abely. The chairman yields at this time to my colleague from Ohio for the purpose of introducing the executive directors of the National Association of College Stores. Mr. Pease.

Mr. Pease. Thank you, Mr. Chairman.

It is a privilege for me and a pleasure to welcome my constituents to the subcommittee today. Mr. Garis Distelhorst is the executive director of the National Association of College Stores, and Paul Mares, the outgoing president of the board of that organization and also the director of the University of California at San Diego Bookstore.

Mr. Chairman, the National Association of College Stores has been headquartered in my hometown of Oberlin for well over 30 years. It is a highly responsible citizen of our community.

Mr. Distelhorst, in the few years that he has been there, has been an outstanding executive director and has added a great deal to the business and civic life of the community.

It is with great pleasure that I welcome him and Mr. Mares to the subcommittee today.

Mr. **Rangel**. Thank you. It is quite an introduction for a constituent who can't vote or pay taxes, but I appreciate that.

The panel recognizes the restrictions that you have on the time of your testimony, and I would advise you to highlight it.

Without objection, your full statements will appear in the record. That would afford the members of the committee to respond more time asking you questions.

We will proceed by having the representative of the National Association of College Stores from Oberlin, Mr. Distelhorst.

STATEMENTS OF PAUL MARES, OUTGOING PRESIDENT OF THE BOARD, NATIONAL ASSOCIATION OF COLLEGE STORES, ACCOMPANIED BY GARIS DISTELHORST, EXECUTIVE DIRECTOR

Mr. **Mares**. I am Mr. Mares. I will be presenting our testimony. With the subcommittee's permission and to allow maximum time for specific questions, I shall limit my formal statement to six basic points.

First, institutional college book stores exist solely to serve the educational needs of our increasingly diverse campus populations across the country. Sales of textbooks and educational supplies typically reflect over 80 percent and in many instances 100 percent of campus bookstore revenues.

Second, and to a much lesser extent, some campus bookstores sell soap, toothpaste and certain other items which enhance the quality of life for members of the campus community.

Bookstores sell these convenience items at prices equal to or higher than those found in private sector businesses.

Third, in reviewing UBIT options presently under subcommittee consideration, we are concerned that UBIT changes likely to shift bookstore revenues from tax exempt to taxable status could increase costs to the campus community.

Bookstores would obviously be forced to pass on any increases even though most students are not in a position to bear such increases.

Fourth, we respectfully urge the subcommittee to focus carefully on whether present UBIT law as applied by the IRS, in fact, resolves all legitimate concerns raised to date about campus bookstore activities.

We would point out that items such as designer jeans, appliances and expensive jewelry sold only in a handful of stores are already subject to UBIT.

NACS strongly supports the April 15 Treasury recommendation to codify previous IRS rulings applicable to campus bookstores.

Fifth, NACS does not believe there is a factual basis for unfair competition complaints against campus bookstores.

NACS has long been sensitive to private sector concerns because we have over 300 private for-profit store members. NACS was among the first organizations in the country to adopt a member competition policy previously provided to the subcommittee, which encourages its members to work with the private sector to resolve problems locally.

Finally, we all know that any change in UBIT law has the potential to harm higher education. Before the law is changed to increase taxes on campuses, Congress should be confident that there is really a problem requiring correction and that it knows what impacts of the solution will be.

We thank you for the opportunity to appear here today and welcome any questions you might have.

[The statement of Mr. Mares follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF COLLEGE STORES

Mr. Chairman and Members of the Subcommittee:

My name is Paul Mares, and I presently manage the University of California at San Diego bookstore. I am also outgoing President of the National Association of College Stores, and have been active on the NACS board for several years. Accompanying me are NACS Executive Director Garis Distelhorst; John Francis, our special tax counsel; and former Congressman Mike Barnes, NACS Legislative Counsel. We have also asked Dr. Caspa Harris, NACUBO Executive Vice President, to join us as someone exceptionally well-suited to address questions on how campus bookstores relate to other campus educational service activities.

It is an honor to appear before this Subcommittee and assist in these important deliberations on the Unrelated Business Income Tax issue. Recognizing the interest developed in campus bookstores since Subcommittee UBIT activities began last year, we hope today's appearance will enable you to understand campus bookstores more fully in assessing present UBIT law.

With Subcommittee permission and to allow maximum time for specific questions, I shall limit my formal statement to six basic points. I would refer you to the August 5, 1987 and April 15, 1988 NACS submissions to the Subcommittee for our more detailed UBIT position. I would further add that NACS endorses the American Council on Education UBIT position presented today.

First, institutional college bookstores exist solely to serve the educational needs of our increasingly diverse campus populations across the country. This service mission guides everything bookstores do, and we take pride in trying to fulfill it. NACS has previously demonstrated to the Subcommittee that campus bookstores concentrate by far the bulk of their activities on selling textbooks, related reading materials and educational supplies. These sales typically reflect over 80 percent, and in many instances 100 percent of campus bookstore revenues. About 17 percent of campus bookstores sell computers, because like textbooks, personal computers have become essential learning tools. Campus bookstores make computers available only to students, faculty and staff subject to terms and controls rigidly imposed by manufacturers to prevent competitive abuses.

Second and to a much lesser extent, some campus bookstores sell soap, toothpaste and certain other items which enhance the quality of life for members of the campus community. The ability to make such purchases on campus as a convenience frees up valuable time for spending on primary educational pursuits. Bookstores often sell these convenience items at prices equal to or higher than those found in private sector businesses in order to cover losses incurred from selling textbooks. Such losses result from a need to assure that textbook prices, by far the largest student expenditure in campus stores, remain as low as possible. Textbook margins average less than 25 percent, far below normal commercial levels, because most students cannot afford to pay more for them. To meet their operating expenses (as many are required to do under their own state laws), bookstores must charge higher prices on other items. We are concerned with any legal change which would upset this delicate pricing balance and possibly increase student costs.

Third, in reviewing the UBIT options presently under Subcommittee consideration, we are concerned that UBIT changes likely to shift bookstore revenues from tax exempt to taxable status could increase costs to the campus community. Bookstores would obviously be forced to pass on any such increases, even though most students are not in a position to bear them without raising taxes for additional educational funding assistance. Such a result could well occur with the adoption of certain proposed Subcommittee options. For example, adoption of any "inherently commercial" test, or elimination of the UBIT convenience exemption without simultaneously broadening the current "substantially related" standard would make campus bookstore services more expensive. The proposed "inherently commercial" standard seems especially problematic in the college bookstore context because most store managers would have difficulty understanding how to apply it. Broadly enough interpreted, all campus bookstore activities could be "inherently commercial." NACS thus concurs in the April 15, 1988 UBIT Comments by Treasury that the standard is unworkable. We are also concerned about the "bookkeeping nightmare" likely to result from repeal of the UBIT convenience exception as cited in the April 15 University of Texas System UBIT Comments. Most college bookstores are on small to medium-sized campuses with limited administrative capability, and we urge the Subcommittee to assess administrative burdens likely to result from any such change.

Fourth, we respectfully urge the Subcommittee to focus carefully on whether present UBIT law, as applied by IRS, in fact resolves all legitimate concerns raised to date about campus bookstore activities. We would point out that items such as designer jeans, appliances and expensive jewelry, sold only in a handful of stores, are already subject to UBIT. To encourage legal compliance, NACS has published articles in our College Store Journal over the past several years describing in detail two key IRS rulings which provide clear guidelines about specific store activities subject to UBIT. NACS strongly supports the April 15 Treasury recommendation to codify these rulings, preferably as IRS regulations, to assure their uniform application. We also refer the Subcommittee to NACS studies and other documentation provided last summer which demonstrate bookstore compliance with all legal tax requirements, including UBIT. In fact, some campus bookstores pay more in taxes than many small businesses. This suggests that present UBIT law is working as applied to the bookstores.

Fifth, NACS does not believe there is a factual basis for unfair competition complaints against campus bookstores. NACS has long been sensitive to private sector concerns because we have over 300 private, for-profit store members. NACS was among the first organizations in the country to adopt a member competition policy, previously provided to the Subcommittee, which encourages its members to work with the private sector to resolve problems locally.

Finally, we wish to express an underlying concern regarding any change in present UBIT law absent more detail about the economic impact of such change. There is a growing recognition among all involved in UBIT issue that available information is sketchy at best. Since most contemplated changes could adversely impact non-profit, tax exempt institution ability to continue meeting basic educational and charitable needs, adequate information about this impact would seem desirable before initiating any legislation. NACS will fully cooperate with the Subcommittee in using our own information collection capabilities to assist in accomplishing this objective.

We thank you for the opportunity to appear here today, and welcome any questions you might have.

Mr. **Rangel**. Thank you very much.

Mr. Marzio.

STATEMENT OF PETER MARZIO, DIRECTOR OF THE MUSEUM OF FINE ARTS, HOUSTON, TX, REPRESENTING THE AMERICAN ARTS ALLIANCE

Mr. **Marzio**. I am Peter Marzio, director of the Museum of Fine Arts, Houston, and I am here today as the representative of the American Arts Alliance. The American Arts Alliance is a consortium of non-profit performing and exhibiting arts institutions in the fields of opera, dance, theater, symphony orchestra, and the visual arts.

I am here to tell you of the extreme concern there is in the arts community regarding the unrelated business income tax "discussion options" listed in the Oversight Subcommittee's press release of March 31, 1988. Decreased Federal moneys, the elimination or reduction of tax incentives for charitable giving; for example, a survey by the Association of Art Museum Directors shows a decrease by 58 percent over last year in contributions of valuable works of art—uncertain financial markets and rising costs left arts institutions struggling to make ends meet. The spectre of added tax on earned income is a significant threat.

Moreover, the threat is not just financial. Several of the options strike at the very heart of the exempt mission of arts institutions.

With that said, I would like to comment on how the options are likely to affect the arts. A number of the options are of critical concern, but it is difficult to rank them, because they affect the diverse members of the arts community in different ways. For instance, performing institutions are tremendously affected by the subcommittee's option dealing with advertising. Art museums, on the other hand, are more touched by the option affecting on-premises and off-premises sales.

Of most concern, however, is the move away from the relatedness standard. This departure runs the risk that activities will be evaluated independent of an institution's overall educational mission.

The move away from the "substantially related" standard has tremendous implications for art museum and performing arts institution shop sales. A vital part of a nonprofit arts group's tax-exempt mission is to educate the public. Gift shop sales are intrinsically linked to that effort. Providing a wide range of materials on the background and interpretation of an art work at hand, including many that are broader in scope than an institution's particular collection, is fundamental.

To require that items sold relate directly to the "organization visited" rather than the "educational nature" of the organization may restrict the educational mission of nonprofit arts institutions.

A "directly related" test, for instance, might bar a museum from selling a book on the general history of art that is as important to understanding a particular exhibit as a catalog devoted exclusively to the exhibit. Similarly, it could prevent an opera company from selling a book on the development of opera, which can shed as much light on a given evening's production as a more specific libretto.

The subcommittee's proposal to tax all off-premise sales calls into question ticket sales made by mail and by phone. In addition, it threatens catalog and satellite shop sales to individuals who are unable to actually visit the institution.

On a separate point, the subcommittee recommends changes in the area of advertising. Advertising is an important way for arts institutions to help cover the costs of performance programs distributed free to patrons. Ticket sales do not include the cost of these educational materials; their cost must be made up elsewhere. The ability of arts groups to continue offering the programs and other publications they use to inform and educate audiences will be limited if advertising income cannot be offset by the costs of the entire publication.

The royalties that arts institutions earn come from such products as opera, dance and art museum videos, symphony recordings, and theatrical productions. These products relate directly to the arts group's mission and are important to efforts to make the arts broadly available to many audiences.

Arts groups must be involved in the development of the product in order to ensure its quality. To tax them on the royalties from the products simply because they had a hand in developing the product, and to throw into question the relatedness of products that earn royalties, will strike a severe blow to arts institution finances.

Mail list exchanges are an important means by which arts groups keep their mail lists up to date and inclusive enough that the broadest possible audiences can be reached with news of upcoming events. In the long run, this helps them realize greater earned income. To tax exchanges would drain money from earned revenue and create a greater dependence on contributed and Federal support.

Facilities rental is also under consideration by the subcommittee. Many arts institutions incur huge costs in maintaining the buildings they operate. Facility rental is an important means of defraying costs. It seems only fair that a tax-exempt group be allowed to utilize overhead and depreciation, as a taxable business is, when computing its taxable income.

The subcommittee would also tax certain fund-raising efforts. To impinge on the good-faith efforts of nonprofit arts groups to raise money for the programs they offer by taxing fund-raising efforts is destructive to fiscal health.

Another subcommittee option, to tax most travel and tour services, raises other considerations. Specialized travel programs are used as an extension of an arts institution's educational mission. These trips, which are designed to focus on the cultural aspect of the place visited, are often initiated by the institution's staff or directors. However, the planning and organization of such trips is in almost all cases handled by commercial travel agents or companies, not the institution itself.

Mr. Chairman, I appreciate the opportunity to be here today to tell you of the impact your subcommittee's discussion options could have on the nonprofit arts community. As I think, and hope, I have made clear, the results could be disastrous. I urge you, on behalf of all the members of the American Arts Alliance, to proceed with care in your review of the discussion options, and to reject those that would tie the hands of arts institutions as they struggle to keep their doors open to the public.

Mr. RANGEL. The American Society of Travel Agents, Earlene Causey.

STATEMENT OF EARLENE L. CAUSEY, PRESIDENT, V.I.P. TRAVEL AGENCY, BAYTOWN, TX, REPRESENTING THE AMERICAN SOCIETY OF TRAVEL AGENTS, INC., ACCOMPANIED BY BARBARA O'HARA, DIRECTOR, GOVERNMENT AFFAIRS

Ms. CAUSEY. Good afternoon.

I am Earlene Causey, executive vice president of VIP Travel Agency of Baytown, TX. I am testifying on behalf of the American Society of Travel Agents, ASTA, whose Fair Competition Committee I chair.

Down in Texas, we have a rallying cry when our nationally-ranked football team takes the field: "Hook'em Horns." Mr. Chairman, the travel industry today finds itself hooked on the horns of a dilemma.

The travel agency industry is rapidly growing. We are the second fastest growing business sector in the United States, and we currently are the third largest U.S. retail or service industry in terms of gross sales. Because of this, over the past decade, many tax-exempt organizations, hard-pressed for income for a variety of reasons, have entered into the travel and tour marketplace in direct competition with our members.

"Because of their lower overhead, multiple benefits and subsidized status, they have been able to offer tour packages, for example, at an average 22-percent lower rate than taxpaying small businesses."

And who are the increasing promoters and travel brokers? None other than colleges and universities, alumni associations, fraternal organizations, churches, civic clubs, senior citizens' groups, and governments.

A classic example is this brochure from the city of Arlington, TX, water utility which I would like to enter in the record at this time. This brochure is mailed with the water bill to all citizens of Arlington. It promotes tours and trips arranged by Arlington Parks and Recreation Department to such places as Colorado for ski trips and the Rio Grande Valley for river rafting.

These new forays into the competitive world truly fall under the following definition of unfair competition:

> Unfair competition occurs as a result of a government-subsidized entity or tax-exempt organization's frequent and ongoing sale of goods or services which are also sold by the private, tax-paying sector, with the privileges of the organization's tax-exempt status employed in the development, promotion, sale and/or operation of those goods or services.

We welcome the efforts of the subcommittee to address abuses and attempt to provide a more level field where we all can compete fairly at what we do best.

Furthermore, it is clear from the record that Congress did not intend for nonprofits to become travel agents when they granted them tax-exempt status. It was the intent of Congress to grant tax-exempt status to those entities willing to engage in activities the community needed which no one seemed willing to provide without a tax incentive. There is a travel agency in practically every community across this great Nation where the population is over 3,000. They are professionals who are able and willing to serve the community.

Responding specifically to your recent list of discussion options regarding the reform of the unrelated business income tax regulations:

One, the travel industry supports the "directly related" test option. The burden must, we contend, be placed upon the tax-exempt community to prove that their commercial activities are directly related to the purpose for which they received their tax-exempt status originally.

Two, however, should you choose to retain the current, often ambiguous substantially related test and opt for a limited commercial test, thereby imposing UBIT on specific activities whose nature and scope are clearly recognized by reasonable people as inherently commercial and not charitable, we strongly suggest that UBIT be imposed on the sale of tour and travel services.

The only exception to this principle that seems fair to all, at first consideration, would be to exempt those travel and tour services provided by higher education institutions, colleges and universities, to their own students and faculty as part of a degree program-related curriculum. This would not include faculty or administration travel for so-called academic purposes. We strongly would oppose excepting de minimis sales to non-students and faculty, since this could evolve into a major loophole allowing a growing aggregate of sales to the public.

Moreover, the convenience and regularly carried on tests should be repealed, because they mask the true commercial nature of the activity. Because the private sector can amply provide quality, cost-effective travel and tour services, any tax-exempt or governmental organization should be limited to selecting and endorsing a travel or tour agent or service without remunerative benefit to the sponsoring organization. Nor should the selected travel or tour service provided be allowed to avail themselves of the benefits of the tax-exempt organization: For example, free public service advertising; third class, nonprofit mailing privileges; use of the tax-exempt's 800 telephone number; or free office space. All of these would entail subsidies on the part of all taxpayers.

No longer should a university like the University of Michigan be allowed to conduct up to 32 different worldwide tours for its alumni and the public, and not pay taxes on its profits. No longer should three churches, three AARP chapters, Arizona State University and the Telephone Pioneers run public service ads in the Sun City, AZ newspaper advertising their far-flung tours and not pay taxes on their profits.

Mr. Chairman, the pursuit of more and better information should not deter you from taking action now. Help us off the horns of our dilemma. Even a little unfair competition is still unfair competition. And believe me, we are facing a virtual stampede that must be fenced in fairly.

Thank you.

Mr. **Rangel**. Thank you.

Mr. Abely, chairman of the Baetech Publishing Co., representing the Association of Business Publishers.

STATEMENT OF JOHN K. ABELY, CHAIRMAN, BAETECH PUBLISHING CO., TEANECK, NJ, REPRESENTING THE ASSOCIATION OF BUSINESS PUBLISHERS

Mr. **Abely**. Thank you.

Since my testimony has been filed, I would like to make perhaps three brief points: First, in addition to being the chairman of a small, growing, taxpaying publishing company, I am formerly chairman of the Association of Business Publishers.

During my career of nearly 30 years, I would like to point out to the members of the committee, that for a period of 4 years, I was an advertising sales executive with a major not-for-profit publishing entity, and that as president of a taxpaying multiple publication company, published the official journal of another not-for-profit organization on a royalty basis.

With me today is Stephen Feldman, Wyatt & Salztein, which is counsel to the Association of Business Publishers.

That the sale of paid advertising is a substantially unrelated business activity has been established time and time again, first by Congress in 1969. It is detailed in section 513 of the IRS Code. That the substantially unrelated nature of the sale of advertising by not-for-profit organizations was reaffirmed by the Supreme Court in 1986.

The issue, it seems to us, really is how to collect the tax. It also seems to us as we compete with a large number of nonprofit organizations, that somebody hasn't been doing a very good job.

We support discussion option J under which principle the net advertising revenues minus the direct expense related to the acquisition of those advertising revenues would become the tax liability of the not-for-profit publishers.

The other option, of course, available to not-for-profit publishers is simply to spin off their publishing activities in taxpaying corporations.

That finishes my remarks, Mr. Chairman.

[The statement of Mr. Abely follows:]

TESTIMONY OF ASSOCIATION OF BUSINESS PUBLISHERS BEFORE THE OVERSIGHT SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE ON THE UNRELATED BUSINESS INCOME TAX

MAY 9, 1988

My name is John K. Abely. I am Chairman of Baetech Publishing Company, Teaneck, New Jersey. We publish Computer Decisions, which is a leading monthly journal edited for managers responsible for corporate information systems. I am a former chairman of the Association of Business Publishers.

ABP and for-profit publishers like myself who are members of ABP have been foremost supporters of the unrelated business tax and its application to advertising income of periodicals published by tax exempt organizations. Our activity in this area goes back to 1960 when ABP urged the Treasury Department to treat advertising income as unrelated to the exempt purposes of a non-profit organization.

In 1967, despite the determined opposition of the non-profit lobby, Treasury implemented regulations applying the tax to advertising. In the midst of opposition voiced by nonprofit periodicals that did not want to pay taxes, ABP stood by those in Congress and at Treasury who supported fair competition and the tax on nonprofit advertising profits.

In 1969 ABP testified before the Ways and Means Committee and the Senate Finance Committee in support of what became Section 513 of the Internal Revenue Code. That section, entitled "Advertising, Etc., Activities" stated that the presence of advertising in journals published presumably for tax exempt purposes did not endow advertising with a tax exempt character. Congress recognized advertising for what it is - a business- subject to the same tax as advertising income earned by me or any other tax paying publisher.

Congress knew when it passed the 1969 unrelated business tax on advertising, (which affirmed the earlier treasury regulations) that tax avoidance devices might be invented by an assortment of professional associations, organizations and societies that sell advertising.

Here is what the House Report had to say:

> The Secretary or his delegate is to prescribe regulations respecting the allocation of income and expenses and other deductions which are attributable to the unrelated activity so as to clearly reflect unrelated business taxable income from such activity, and to prevent avoidance of unrelated business income tax liability.

The Senate Report had similar language. Congress was right about tax avoidance, because as soon as the statute was passed, in 1969, non-profit organizations commenced to lobby the Treasury Department to adopt regulations that would have allowed them to escape the tax and thus compete with an unfair advantage over taxpayers.

ABP's testimony last summer before this Subcommittee described the head to head competition that exists in every field, both business and consumer, between for profit publishers and tax exempt organizations. I reaffirm that testimony from my own 30 years of publishing experience.

In the medical field, the Annals of Internal Medicine, published by the American College of Physicians, competes against the American Journal of Medicine, against Modern Medicine and Patient Care. The Journal of the American Medical Association likewise competes against those and other for-profit medical journals. In the field of computer publishing, in which I am now engaged, IEEE (the Institute of Electrical and Electronic Engineers) publishes an array of computer and electronics journals which aggressively seek advertising market share using the same selling methods as for profit publications. And ABP member Nature magazine, one of the world's leading scientific weekies, has to endure the unfair advantages enjoyed by Science, published by the American Association for the Advancement of Science, which has filed comments pleading for more loopholes in the advertising tax.

While the law states that advertising income should be taxed in order to effect competitive equality, the reality is that those tax-exempt organizations have an advantage over publishers in the private sector, that advantage being dues income, a portion of which is used to finance the publishing of magazines, which in turn are used to sell advertising. Thus the pleas to this Subcommittee by the American Medical Association, the American Institute of Architects, the American Society of Association Executives and the American Association for the Advancement of Science that circulation expense should be deductible ring hollow because their circulation income is tax exempt. They say that they just want to be treated like for-profit publications. They can be: Let them spin off their publications into tax paying businessess.

AMA, AAAS and ASAE went all the way to U.S. Supreme Court in 1986 to void the tax on advertising completely in the American College of Physicians case. Their theory was that if advertising appears in a tax exempt journal, it must have an educational purpose and therefore should not be taxed at all. IRS and ABP opposed this in the Supreme Court.

The U.S. Supreme Court agreed that Congress meant in 1969 that advertising should pay a tax, whether those profits are earned in the Journal of the American Medical Association, or in the for-profit American Journal of Medicine, in non-profit Smithsonian Magazine or in for-profit publications like Atlantic. The Supreme Court stated:

> Congress has declared unambiguously that the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational articles and editorial comment.

Even after the Supreme Court held that advertising income, even if derived from medical or scientific advertisers, was taxable, non-profit organizations have tried to shape accounting regulations so as to achieve their original goal of non-payment of tax on advertising income. That is why ABP members are encouraged by the interest this Subcommittee has shown in strengthening the tax. The Court's segregation of advertising from editorial activity as being "distinct" provides support for the proposal by the Subcommittee that only direct advertising expense be deducted from advertising income, and not circulation or association expenses, which are being so deducted. That is the crux of the matter.

There are two ways the UBIT applied to advertising can be improved: The first method would be the Subcommittee's proposal to limit deductions against advertising income to direct advertising expense. If this were done, it would prevent publications like JAMA from artificially designating a low or no subscription price for all or a part of its circulation. This manipulation of the amount of dues income attributed as circulation income allows organizations like AMA and the American Hospital Association among others, to maximize the excess of circulation expense over artificially depressed circulation, then deducting the expense from advertising income, thus avoiding tax.

When a supposedly nonprofit organization like the American Institute of Architects writes to this committee that it ought to be able to deduct excess circulation expenses against advertising income because commercial publications can do so, it concedes it is in the same publishing business as its for-profit competitors. But AIA publishes Architecture, which competes with the for-profit Progressive Architecture. Progressive Architecture pays taxes on its subscription income as does any corporate publisher who earns circulation income. But the AIA's periodical does not pay taxes on the $30.00 it charges as a subscription price.

The editorial content of Progressive Architecture surely is not of any less value than the non-profit Architecture. Why should AIA be able to write off editorial expense, but not pay tax on editorial income? The Subcommittee proposal would rectify this inequity.

The second alternative the Subcommittee might consider is taxing circulation income of tax exempt journals that carry advertising but derive 50% or more of income from subscriptions. This would include journals like National Geographic with enormous circulations and subscription income and with substantial but less than 50% advertising income. Under this proposal there would be a similar treatment of income and expense of nonprofit journals and for profit journals under this alternative.

I appreciate this opportunity to appear before the Subcommittee. I am available to answer any questions the members may have.

Mr. RANGEL. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I would like to thank this panel. I have so many questions, but I am trying to limit myself because time is a problem.

First, Mr. Marzio, is there any limit you would put? From your testimony, I have to assume that you would say any way that you can stretch it to make it related, that it is OK? In other words, you can take bus trips. I realize if you take a bus trip with an art group that you might say look at that magnificent tree. Maybe some day you would like to paint it. In that way you could make it related to almost anything.

I have just been handed a couple of catalogs from art museums that I have never seen before selling a scissor set manufactured in the People's Republic of China, a barbecue set, a rake for those hard-to-reach areas. Those are just some of the things—bubble gum.

I suppose there is a way you can stretch all of these things and justify them.

Is there a limit? Is there any area where you would say, stop? Is there sort of the amusement park syndrome where you would say, there is a limit? Let me tell you one of my concerns.

Ten, maybe 14 years ago, we should have said to the bankers of the United States of America, when "go-go" banking first started, stop, that is enough, slowdown. If we had grabbed them by the lapels and said, wait 1 minute, don't go too far, then we probably would have been performing a valuable service.

Yet, people would have said, you are trying to intimidate the banking community of the United States. We didn't do that. We thought a lot of them would learn by what they saw happening.

Apparently, they didn't. If we could collectively take the nonprofit segment of the American economy by the lapels and say, wait a minute, don't go too far, just because somebody else is raising money that way, don't you become tempted then it might be helpful. But I don't think that is going to happen.

I don't know, I am afraid it might be the same as the banking community. We will regret not having done it. But do you think there is a limit? Is there somewhere where we should draw the line, or should we step back and say everything that you want to do is all right?

Mr. MARZIO. I think the spirit of the law, as I understand it, and I am not a lawyer, but the phrase that has always been my guiding principle is what I learned in college. It was a Supreme Court decision, which said on the one hand that the purpose of this legislation was to encourage benevolent enterprise.

On the other hand, the Supreme Court said, it was to restrain unfair competition. Now, that is sort of having it both ways, wanting your cake and eating it, too. That essentially is the horns of the dilemma.

I don't believe in a total lack of restraint. Taking your example of a day in the country to look at a tree with the notion that you could get people interested in becoming watercolor artists, I would say that is probably over the line. And I am the first one to admit that there are items——

Mr. SCHULZE. The example of lines has to be somewhere a little further than that.

Mr. MARZIO. I would agree.

Mr. SCHULZE. Go ahead. I interrupted you.

Mr. MARZIO. Just as the law is difficult for IRS agents to come to a clear, honest determination of where they should stop their efforts, I think it is true on the other side of the coin as well. And one of the important functions of these continuing hearings, I think, is making people think more about the issue.

The thrust of my testimony is simply that I think the American cultural system is extremely strong, and I think it is the envy of the world. And I just worry when I see people overreacting to extreme cases. We can all cite extreme cases in almost any kind of activity where law is involved.

Mr. SCHULZE. You don't see any danger in catalog sales becoming too large in the name of charitable contributions?

Mr. MARZIO. I think it depends on what we mean by large. If we mean, a blockbuster exhibition and the catalog suddenly sells 300,000 catalogs——

Mr. SCHULZE. Suppose there is a museum smaller than this room, let's say. But they send out 4.5 million five-color catalogs all over the world. Suddenly, their sales are in the millions from the catalog sales. And it is written in the catalog, join us now and receive discounts of 25 percent on merchandise in this catalog.

There has to be a line somewhere. Why can't the museums say here is a sensible line? I try to stretch my imagination, but I cannot understand how underwater equipment, and swim fins, could be related to sales by an art museum. How would you limit that kind of thing?

How would you say it should be related? If you are selling prints of some of those paintings which are displayed in the museum, I believe that is directly related, and is part of your function, and we ought to encourage it.

But where they are selling swim fins, it is hard for me to make that connection.

Mr. MARZIO. I think the dilemma in that case, and you have brought up probably the most difficult area—museums that have large, modern design departments. For these museums curators select what they regard as the best in both mass production and unique production of works that are available in regular stores. They believe that a way of establishing a high sense of design in the citizenry is to put these on exhibit in the museum as examples of good design.

Because it is in the museum collection, the next logical step in the museum's minds, therefore is that the object can be sold in the museum shop. I think that is an area that can certainly be looked at.

Mr. SCHULZE. Do you see that is an area where someone who was perhaps a little unscrupulous could say if they can do that, I can do that and make a fortune? How do we protect from that?

Mr. MARZIO. I think from the——

Mr. SCHULZE. Without destroying the initiative of the genuine art museum.

Mr. MARZIO. I think when the cases become extreme, as you are saying, it should be fairly obvious. I don't imagine that kind of operation going on for very long, just as you won't have a fraudulent bank surviving for very long.

Mr. SCHULZE. When an art museum decides to send out a piece like this, do they try to determine whether that will be economically successful? Do they do it in order to make a profit or do they say, "This is a public service. We want people to see these modern products, and we don't care whether we make any money or not. We are going to sell this thing out, and we are going to sell 1 percent. Even if we lose $2 million a year on our catalog, we think we are performing a service."

Or do they say these products will be in there because they make money?

Mr. MARZIO. In my experience, there have been two concerns.

One, that the objects carry the mission of the institution forward; and two, that they don't sink the institution in the process with things people will not buy.

Mr. SCHULZE. Catalogs across the country, do they make money, or lose money?

Mr. MARZIO. I honestly don't know.

Mr. SCHULZE. Would there be a reason for not putting some kind of a limitation on catalog sales? Say as a percentage of your overall business?—I just don't want the tail wagging the dog. Or say you can have catalog sales and write to your members and say since you have been unable to come in, we have some prints that are available at the bookstore?

How about if those catalog sales could be doubled the amount of entry fees paid or some sort of measurement? Is there a formula, a reasonable formula which could be used?

Mr. MARZIO. I think your previous line of questioning is the area that I would look into, that is, the kinds of things being sold in the catalog. I do not think there is any reason to limit volume.

Mr. SCHULZE. So that if a small museum deliberately set out to capture the catalog market and sent 8 million catalogs out across the country because they selected items for their appeal to put in that museum, you would say that would be all right?

Mr. MARZIO. No. I would——

Mr. SCHULZE. We have to deal with the unscrupulous as well as the public-spirit citizens.

Mr. MARZIO. We were talking about scale, that is relationship to revenues at the door, whatever the other standard is.

The example I would use to make my point clear is this. Say you were a museum that had a collection of impressionist masterpieces. Right now, big picture books on impressionism sell very well.

Let's say this small museum, maybe it only has 200 pictures, has developed 50 major coffee table-style books and put out a catalog.

Each book winds up selling 50,000 copies or more. That would be a revenue far in excess to probably 3 or 4 years of an operating budget. I would not think that would be inappropriate.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Pease.

Mr. PEASE. Mr. Chairman, I appreciate very much the indulgence of the Chair in allowing me to participate in this hearing.

I have just a couple of questions.

One, Ms. Causey, you have piqued my interest in the question of travel. I had not really thought about that before.

I regularly get solicitations from the alumni association of my university for trips overseas. I guess I have always assumed that they make arrangements through a travel agent for those trips.

Is that an incorrect assumption on my part?

Ms. CAUSEY. I would say a small percentage do make them through travel agents or through a tour company directly. The problem with that is that, if you will, the notice, a good percentage of the ones I have seen, at least, instead of the payment and the form going back to the travel agent, it actually goes to the alumni association or what have you.

So, you have the alumni association people handling all of the paperwork and what have you on the tours.

Mr. PEASE. Well, let's say there is a tour of the Soviet Union. What would be the difference in economic terms between a university alumni association offering that tour and a commercial travel agent offering the tour?

Ms. CAUSEY. Lots of times the prices are the same, and sometimes the alumni association price is more because they factor in the cost of a professor or additional people going on the tour.

Mr. PEASE. Is there an element of unfair competition if the prices are the same or higher?

Ms. CAUSEY. Well, our feeling on this is that the governments are not receiving the tax on profits that is earned.

Were a travel agent to do it solely, then the city, State and Federal Governments would be getting tax on the income earned from that.

Mr. PEASE. OK. I think that is a good point, but you do not make the point that the nontax status of an alumni association, for example, allows it to compete unfairly against commercial travel agents.

Ms. CAUSEY. A big part of the unfair part of it was what I mentioned in my statement where they have use of the facilities at a university office space and a lot of times volunteer help. They have the mailing list, 800 numbers.

Also, we all hear on our local radios when they make public service announcements, these things are included in that.

Mr. PEASE. I understand that. I guess from what you are saying, it appears to me that the nonprofit organizations do not translate those advantages—volunteer help, mailing lists and so on—do not translate those advantages into lower prices.

Do I understand you correctly?

Ms. CAUSEY. I think that is correct most of the times, yes.

Mr. PEASE. Your basic position is that taxpayers are being denied a fair amount of revenue on those sales?

Ms. CAUSEY. Yes, and we are helping to subsidize that by our tax, like on the nonprofit postage and that sort of thing.

Mr. PEASE. I see.

Thank you.

Mr. Abely, you are making the point that advertising in publications of nonprofit organizations is a form of revenue that ought to be taxable revenue? Is that correct?

Mr. ABELY. That is currently taxable under section 513(c) of the IRS Code.

Mr. PEASE. What are you urging upon this subcommittee?

Mr. ABELY. Although it is currently law, it seems that the definition of what profit stems from that activity is perhaps inadequately defined. And that is why I said that we support proposal J, discussion point J.

I mentioned before that as a tax-paying publisher, we published the official journal of a not-for-profit organization on a royalty basis.

What is interesting, the basis of that royalty was a percentage of the advertising income that we were successful in attracting to the publication.

How that not-for-profit organization dealt with that is a question that I probably can't answer.

The question of royalties, of course, keeps coming up. In many cases, it would seem to some of us in the publishing business, that royalties become a tax avoidance system.

Mr. PEASE. I see.

Thank you, Mr. Abely.

I am aware, Mr. Mares, that the National Association of College Stores publishes a journal called College Stores, and it has a substantial amount of advertising.

Could you tell me how that is handled; or Mr. Distelhorst, either one?

Do you pay taxes on that revenues?

Mr. DISTELHORST. Yes, because the advertising revenue exceeds the expense of producing the magazine, we have paid taxes.

Mr. PEASE. The taxes that you pay are calculated on the basis of the separate activity of publishing a magazine? You figure the expenses of the magazine and the revenue, and pay taxes on the difference?

Mr. DISTELHORST. That is correct.

Mr. PEASE. Do you pro rate the expenses of personnel within ACS to the magazine for those purposes?

Mr. DISTELHORST. Only the directly related, the advertising sales force, in our case, the editorial staff, not corporate overhead, not any of my time as the chief executive officer.

Mr. PEASE. An allocation for rent or heat or light or that sort of thing?

Mr. DISTELHORST. We have a finance administration charge for the computer charge for the collection of bills, advertising and subscribers.

Mr. PEASE. One other thing. I might ask NACS, out of curiosity, are you in the travel and tour business? If so, how do you handle it?

Mr. MARES. We are not in the travel and tour business in the book store.

Mr. PEASE. I appreciate the Chair's indulgence. I think we ought to call attention to the fact that one of the resource persons available from NACS is our former colleague, Mr. Barnes.

Mr. RANGEL. Let the record so state. It strengthens the case tremendously.

Mr. PEASE. Thank you.

Mr. RANGEL. Mr. Mares, I appreciate your cooperation as relates to the sales in book stores. You know the problem, and obviously you are stating that most of your members try to comply with the law. And, of course, where you do find the exceptions is where the attention is being focused.

That is why, Mr. Marzio, I get the impression from your testimony that you are driven by the protection of the arts rather than having a closer connection between the item being sold and the actual nonprofit that is involved.

There is nothing closer to me than the preservation and protection of the museums, especially the school museum.

Your testimony doesn't appear to want to take in consideration that there is abuse, and certainly not by the majority, but probably by a few.

It does help when your testimony is a little more balanced as in the case of some of the museums that are accused of selling furniture because they are replicas of some pieces that may be in a museum, where clearly it is profit motivated and not a souvenir or reminder of a cultural experience.

And some of the other things that you define as being cultural or educational, you yourself admitted that there has to be some line between what the connection is between what we want to support and how it could put somebody who is in this business that does not have the broad latitude as nonprofits in an extremely competitive and unfairly so.

We all recognize our support of the arts is primarily voluntarily, and we want to encourage that, but unless we can get the cooperation of organizations such as yours to point us in the right direction as to what appears to be fair, then we don't have the balance when we make our decisions here.

Mr. MARZIO. There are two points in response, sir, that I would like to make.

I respectfully disagree with your feeling about furniture. On the role of Colonial Williamsburg and the way they went about reproducing 17th and early 18th century furniture, which is unique to their collection, I think those works do a lot to help us understand the proportions and the color and the nature of the environment in the colonial period.

Mr. RANGEL. You can continue to believe it, but at some point there is going to be a protest from those people that make furniture for a living and have stockholders and pay the taxes so that whatever small contributions we are able to encourage the Congress to do, we can continue to do that.

So there is no question that until the Congress looks at it more carefully, you have a broader latitude than we are going to end up with.

I would think, Ms. Causey, in response to a question by Mr. Pease, that there are any number of tours that are packaged at rates much lower than travel agencies can possibly think of providing. And many of them are not even related to the university systems.

Two or three people from the university want a trip, and they go to the broader population and advertise the trip, and the university people go free. And those that go commercially, that are not connected with the university actually, their price pays for that trip.

Your response to Mr. Pease indicated that your only concern was that they didn't pay taxes, which is virtuous, but I assume that you also are concerned that they are taking business away from you.

Ms. CAUSEY. Absolutely. I didn't mean to give that impression.

Mr. RANGEL. Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Chairman. I was called out of the room and did not hear all of the testimony of all the groups. When I left, Mr. Marzio was commenting.

I would like to ask a broad question of you, and each of the panelists if you want to comment, but specifically in your case, the Arts Alliance represents both the performing arts and the museums.

Now, what options, of those we represented, A through L, do you think are the most serious for the performing arts community or the museums? Which ones would cause you the most concern? Do you have a choice of what would hurt you the worst, either one, two or three?

Mr. MARZIO. The issue dealing with the advertising in the programs of the performing arts organizations. Under the new proposal, as I understand it, the expenses related to soliciting the ads, preparing the ads and printing in the programs those ads would be deducted from the revenues, and then the remainder taxed.

Our strong feeling is that the program itself, that is, the publication, is not in any way covered by the ticket sale to get the person in the seat, and the performing arts groups believe strongly that the entire costs of the production of the program should be deducted and then, if there is a deposit or balance from that, that is what should be taxable.

Chairman PICKLE. Do you have any other category besides advertising?

While you are looking, let me ask one more question in this section.

Museums and bookstores alike assert that there is no competition in question with the catalog sales, yet the catalog sales are growing in number and often it is hard to distinguish between your catalog sale or a commercial enterprise.

Do you pay taxes on any of the sales, any of the items in your catalog?

Mr. MARZIO. We do not have a sales catalog, sir.

Chairman PICKLE. A lot of museums do have catalogs, do they not?

Mr. MARZIO. Yes.

Chairman PICKLE. You represent the Arts Alliance. Those that do have them, do you know if they pay taxes on any sales of any items from the catalog?

Mr. MARZIO. I don't know. But we do have people behind me who can perhaps give that information.

Chairman PICKLE. Do any of you have catalogs?

Mr. MARES. We have catalog sales for alumni. We consider them an integral part of the campus community.

There are a number of reasons why we are in contact with that group of people.

Chairman PICKLE. You are saying you do not pay taxes on any sales of any items; is that correct?

Mr. MARES. We never had income in excess of the cost of producing the catalog. We are involved in the process as a service to our university community.

I am speaking for our campus only.

Chairman PICKLE. Here is a catalog of the Metropolitan Museum of Art. There is the Museum of Modern Art in New York for Christmas 1987. I presume these are typical catalogs. I presume that you pay no tax on any of it.

Does anybody know? Mr. Marzio?

Mr. MARZIO. I don't know, with those specific catalogs. The Met tries to get the IRS to give them an opinion. They do pay tax on unrelated items in their catalog, but I don't know what that number is.

Chairman PICKLE. Will you submit that information to the committee? I would like to know, as a practical matter, what they do. I doubt that many of them do pay tax, but if they do I want to be notified about that.

I wish you would ask your organization how much and in what category they pay tax, if they do.

[The following was subsequently received:]

AMERICAN ARTS ALLIANCE

1319 F Street NW Suite 307 Washington DC 20004 phone (202) 737-1727

May 18, 1988

Honorable J.J. Pickle
U.S. House of Representatives
Washington D.C. 20515

Dear Representative Pickle:

At the May 9 Oversight Subcommittee's hearing on the Unrelated Business Income Tax, you expressed interest in having more information on the amount of Unrelated Business Income Tax the Metropolitan Museum of Art pays. This letter is to respond to that question.

We contacted the Metropolitan Museum subsequent to that hearing to get more detailed information on its sales activity. Based on a comprehensive audit of Metropolitan shop sales covering the years 1978 - 1984, the Museum has been paying UBIT since 1978 on a small group of items declared unrelated to its purpose. These items, consisting primarily of a Christmas snowflake and ornament series and products based on this series, were found to be unrelated because they were original art rather than items based on the Museum's collections.

The following chart shows how much unrelated income the Museum has received, and the corresponding amount of UBIT paid on it, in the past five years.

Year	Net Income From Goods Sold	Net Income Mailing List Rentals	Total UBI (Before Deductions)	Amount of UBIT Paid
1983	$ 302,148	$ 77,756	$ 379,904	$ 40,739
1984	$ 572,995	$ 238,400	$ 811,401	$ 136,796
1985	$ 42,727	$ 250,995	$ 293,722	$ 70,509
1986	$ 17,959	$ 172,450	$ 190,409	$ 29,504
1987	$ 10,045	$ 222,331	$ 232,376	$ 47,495

You will see that the amount of net income from goods sold has decreased radically during the five years, reflecting the Museum's goal to sell only related items.

It is interesting to note that the attached 1983 IRS Technical Ruling affirmed the relatedness of museum sales of slide, poster, post card, greeting card, and sculptural reproductions of artwork; personal items adapted from objects in the museum's collection; and instructional literature concerning the history and development of art. The IRS wrote that determination of a gift shop or catalog item's exemption from UBIT rested on its relationship to the organization's exempt purpose and defined sales of the aforementioned items as clearly related to that purpose.

The IRS went on to say that determination of an item or activity's exempt status should not rest on whether the activity is commercial in nature or in competition with a taxpaying entity. An item's relation to UBIT relies exclusively, it said, on its connection to the exempt organization's purpose.

If it is appropriate to offer publications, reproductions, and other related items within the Museum, as the IRS have determined, it is possibly an even more pressing responsibility to make them known and available to the larger audience outside the Museum. Mail order and off-premise sales are one of the most effective means of meeting this responsibility. Like the reproductions themselves, the mail order catalogs include descriptive, informational text on the items offered for sale. In addition to expanding the public's knowledge of the collections, mail order and other off-premise sales encourage people to visit the Museum. In these ways, these sales help the Museum in its outreach effort.

Another point you raised at the hearing dealt with the relative importance of the subcommittee's "discussion options" to the nonprofit arts community. It is difficult to rank the options because they affect the diverse members of the arts community differently. Some generalizations, however, can be made.

To the performing groups, clearly the question of whether mail and phone-order ticket sales are included in the off-premise sales option is of paramount concern, since these sales are the life blood of these organizations. Also important is the threat that the advertising income from performing arts institution programs and other educational publications offered free to patrons will be subjected to new allocation rules that limit the degree to which costs of the publication can be balanced against advertising income.

For royalties on products such as opera and dance videos, symphony recordings, and theatrical productions to be taxed, when the group logically must be substantially involved in the product's development, raises serious concerns. We do not understand why a tax-exempt arts organization that creates, or is significantly involved in crezating, a property and then renlinquishes control to a separate entity for further development or marketing of that property, may not receive passive royalty income without taxation. In addition, the subcommittee options on facilities rental and mail list exchanges also pose problems to performing institutions.

On the other hand, for arts museums, the option of most concern is that which would subject increasing numbers of gift shop and catalog sales -- comprised predominantly of items related to exempt purposes -- to the UBIT. The narrowing of the relatedness test, especially in relation to on-site and off-premise sales, has negative implications for arts groups. Also important to them, however, are the facilities rental and royalty options.

We hope that this response is helpful in your future deliberations on this important issue.

Sincerely,

Anne G. Murphy
Executive Director

Chairman PICKLE. Mr. Chairman, I thank you very much.

Mr. RANGEL. Mr. Chairman, that concludes this panel.

Chairman PICKLE. Our next panel consists of the American Hospital Association, Monsignor Andrew McGowan; then the Association of American Medical Colleges, Robert M. Heyssel; the Health Industry Distributors Association, Haworth H. Parks, Sr.; and the National Federation of Independent Business, Carol Thompson.

The first person to testify will be Monsignor Andrew McGowan, vice president of the board of directors of Mercy Hospital in Scranton, PA, representing the American Hospital Association.

Then the next witness will be Ms. Carol Thompson, representing the NFIB, National Federation of Independent Business. Ms. Thompson is from Austin, TX, and I am delighted to have you from my home city.

Then we have Dr. Robert Heyssel, representing the Association of American Medical Colleges.

And then we have Mr. Haworth H. Parks, Sr., chairman of the board of the Health Industry Distributors Association.

We will proceed with Monsignor McGowan.

STATEMENT OF MSGR. ANDREW McGOWAN, VICE CHAIRMAN OF THE BOARD OF DIRECTORS, MERCY HOSPITAL, SCRANTON, PA, REPRESENTING THE AMERICAN HOSPITAL ASSOCIATION, ACCOMPANIED BY ROBERT S. BROMBERG, COUNSEL

Monsignor McGOWAN. Sir, I recognize that when someone from Texas is sitting next to me, I am in trouble.

I would like to submit my statement for the record. It probably would be wiser to read it, but I am not known for my wisdom.

The American medical community discovered the "halo" effect but we evangelists have not had a particularly good year.

I came realizing that I would be accompanied by Attorney Robert Bromberg here, who can handle some of the legal problems that disturb us in health care. Our responsibility is speaking for 5,100 members of the American Hospital Association, and if we can alert all of you to our mission and the reason we exist, then the hearings would have accomplished that. We are pleased with that opportunity.

We recognize that Medicare reimbursement is not reaching the cost of living increase and that is becoming a serious problem to our hospitals, as well as the uncompensated care, representing 36 million people with no insurance or underinsured. With the cost shifting that has begun, too, we are not able to make the money to take care of the poor. This is a very critical time for the hospitals of the United States.

The reduced margins, operating margins, are a fact that has been attested to by a number of people.

We had been urged as trustees some years ago to begin to go into other areas when the DRGs first came on board. We were willing to pay the UBIT where there is no problem.

We recognize in some of the testimony today there is an attempt to indicate that we are only talking about inpatients. That is not health care today; 93 percent of all hospitals now offer ambulatory surgical services; 232 million people in 1986 were outpatients. That

13 million increase is the direction we are going in health care, and we would not want the definition to be drawn to exclude even home health care. With the intravenous medical care available, home health care is probably where we will go in treating people with AIDS.

We recognize that the timing may not be the best, when you are looking at a wide variety of businesses, to come in with sweeping changes. We recognize we should have tax for those services which are not directly connected with patient care.

Some of the testimony indicated that the cases represented people who were not patients, but who were receiving lab services or others and the hospitals were not paying taxes. That is not true. The change in the definition, the "continuous care outpatient," is a definition not known in health care. It is a dangerous term.

"Directly related" also presents a number of problems, because "substantially related" has been defined by the courts and IRS, and we understand its meaning and think we can live with it. Something that is "inherently commercial" would not do well.

If the convenience exception is going to be moved, although it is a simplified determination, as long as the determination of who are patients includes outpatients we do not have a difficult time with that.

We continue to understand what our mission is. We continue to take on a major responsibility of uncompensated care.

It seems amazing that nobody has mentioned the patients until now, and we like to think that in our desire to look at that playing field, that people are not going to be hurt.

Garrison Keillor, in his book, said we are what we are, *summus qua summus*. We would like to remember who we are and be mindful of our mission and continue to offer that service.

We will be happy to answer any questions you may have.

Chairman PICKLE. Thank you, Monsignor.

[The statement of Monsignor McGowan follow:]

American Hospital Association

Capitol Place, Building #3
50 F Street, N.W.
Suite 1100
Washington, D.C. 20001
Telephone 202 638-1100
Cable Address: Amerhosp

STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
ON
THE UNRELATED BUSINESS INCOME TAX

MAY 9, 1988

Mr. Chairman, I am Monsignor Andrew McGowan, Vice-Chairman of the Board of Directors of Mercy Hospital in Scranton, Pennsylvania. I appreciate this opportunity to appear before you today on behalf of the American Hospital Association and its more than 5,100 institutional and 40,000 personal members. With me today on AHA's behalf is Robert S. Bromberg, an attorney in private practice in Cincinnati, Ohio, who is a former president of the National Health Lawyers Association with 22 years experience with exempt organization tax law, six years of which were with the Internal Revenue Service national office.

The nation's hospitals today face unprecedented financial pressure and increased responsibility to provide high-quality health care to those who need it, regardless of their ability to pay. Any drastic changes in the tax law that would adversely affect hospitals' ability to raise revenues through all legitimate means could have serious implications for the future health care of our nation.

Hospitals today are struggling to cope with sharply reduced operating margins. Chief among the causes of this weakened financial condition are diminished reimbursement levels relative to the greater cost of treating patients.

Medicare payment increases have lagged well behind health care cost inflation for the first five years of the prospective payment system. In fact, separate findings by the Health Care Financing Administration, the Prospective Payment Assessment Commission, and the HHS Inspector General show that hospital Medicare operating margins are declining significantly. The growing indigent care burden and tight constraints under private health programs also contribute to shrinking operating margins. AHA estimates that more than half of community hospitals lost money on overall patient care in 1986. This trend continues unabated.

Unfortunately, these adverse economic factors exist in an environment in which society is demanding that an ever-increasing range of health care needs be met. Patterns of hospital care delivery have continued to evolve over the past few years, resulting in a net decline in the number of patients treated in hospitals. Almost all community hospitals--93 percent in 1986--now offer ambulatory surgical services. Americans' acceptance of outpatient care as a less-expensive alternative to hospitalization continues to grow, with 232 million outpatients cared for in 1986, 13 million more than in 1985. Sharp admissions declines in the past two years indicate that less-severely ill patients are being treated in non-acute settings because inpatient illness requires longer hospital stays, more resources, and greater cost.

Advances in intravenous medical equipment have allowed care previously provided only in hospitals to be delivered by hospitals to patients in their homes. Ten years ago, fewer than 400 hospitals offered home care services. By 1986, the number had more than quadrupled, to one-third of all community hospitals. In addition, care for AIDS patients, projected to cost $8.5 billion by 1991, is generally provided on a non-acute basis.

The current health care marketplace is highly competitive, diverse, and marked by financial instability and uncertainty. In addition, hospitals must respond to increased demand for cost-efficient, innovative, and coordinated health care delivery methods. Hospitals have had to use every available resource to meet these challenges so they can continue to fulfill their health care missions.

For these reasons, Mr. Chairman, the Subcommittee's proposals to change the unrelated business income tax (UBIT) law could not have come at a worse time for hospitals. Under current law, the IRS' patient/nonpatient distinction admittedly does not tax income for the sale of goods and services provided to patients. But it does tax income derived from the sale of goods and services to persons who technically are not hospital patients, except under special and limited circumstances. For example, sales of pharmaceuticals to off-the-street customers of a hospital's satellite pharmacy and everday diagnostic tests of specimens of private patients of a hospital staff physician are taxed as unrelated business income.

The exemption from UBIT under current tax law for services rendered to all types of hospital patients provides hospitals with the flexibility that is vitally needed to enable them to respond to the continuing changes that are taking place in the delivery and financing of health care.

The Subcommittee's proposals to change the longstanding IRS patient/nonpatient approach by attempting to create artificial distinctions such as "continuous care outpatient," which is not a term of art in health care, strike at the heart of modern health care delivery and threaten to stifle further advances in the extension of services on a less-costly outpatient basis. Significantly, these options ignore the principle that the diagnosis, prevention, and treatment of disease through a broad spectrum of patient care settings is substantially related to the achievement of a hospital's exempt purposes. Hospital services legitimately range from acute inpatient care to care provided in a variety of outpatient settings, extending to assistance rendered in the home and intermediate care and skilled nursing facilities.

Furthermore, although a coherent rationale for the proposed changes is not explicit, apparently the changes are intended to correct alleged inequities in current tax law. However, the description of applicable tax law provided to the Subcommittee is inaccurate and misleading because it attempts to portray certain activities as exempt when they are not. Indeed, the description of current law as exempting hospital income derived from laboratory testing of, and pharmacy sales to, nonpatients from UBIT is at odds with 20 years of established precedent. Based on an accurate description of current law, AHA submits that the patient/nonpatient approach developed and followed by the IRS to determine the taxability of income from hospital activities is reasonable, has not been subject to abuse, and is consistent with the obligation of hospitals to serve their communities through the provision of both inpatient and outpatient services.

AHA agrees with the Treasury Department's April 15 comments that any attempt to supplant current well-reasoned, carefully developed guidelines with ambiguous standards such as "directly related" and "inherently commercial" would sacrifice predictability to chaos and uncertainty. Such a change would have far-reaching implications not only for hospitals but for all charitable organizations.

Finally, exempt hospitals are not unreasonable in seeking to retain current law. Under the law, the sale and rental of goods and services to the general public, or nonpatients, is generally taxable as an unrelated trade or business. We do not seek to change this result. We seek no more than to avoid enactment of changes in the law that would most assuredly make less attractive to our hospitals the continued refinement of outpatient health care that is universally regarded as a less-costly and more desirable alternative to inpatient care.

Chairman PICKLE. Ms. Thompson.

STATEMENT OF CAROL THOMPSON, PRESIDENT, COMPUTERLAND, AUSTIN, TX, REPRESENTING THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS, ACCOMPANIED BY ABRAHAM SCHNEIER, TAX COUNSEL

Ms. THOMPSON. Congressman Pickle and subcommittee members, I am Carol Thompson from Austin, TX, where I own ComputerLand stores and a computer rental company. Accompanying me is Abe Schneier, tax counsel for the National Federation of Independent Business. On behalf of 800 ComputerLand dealers worldwide, I want to thank you for this opportunity.

I serve as a vice chair for small business of the Austin Chamber of Commerce, chair-elect of the Women's Chamber of Commerce of Texas, and on the board of the National Association of Women Business Owners. I was a delegate to both the White House and the Texas Conferences on Small Business. So, you see, small business is more than my livelihood; it is my life, and a uniquely American way of life.

I have been a small business owner for 15 years and in many ways the past 2 have been the hardest. First there was the frustration of trying to get long-term financing, not because of the condition of my company, which grew rapidly, but because of the economy and the banks of Austin. After trying five local banks, I was forced to borrow outside the State.

Next I found myself competing on my own turf against a tax-supported university with all the resources of Texas behind it. You see, both my stores are located less than 10 miles from the University of Texas, one of the richest universities in the world. It is also the second largest single Apple computer dealer in the world. In the past 5 years the university has sold an estimated 8,000 Apple computers. IBM is now set to do the same thing.

This has created a lucrative gray market in computers that cuts deeply into my business. Students, faculty and even university staff buy computer equipment and software at below my manufacturer's cost, then resell them to others, to both individuals and businesses for prices at which I can never compete.

For example, a woman moved to town and I helped her network for a job. Later she bought a computer through a source at the University of Texas. She confessed to feeling badly, but, after all, if it is a $1,000 deal, how could she pass it up to buy from Carol Thompson for $1,500?

Some call this gray market a sales club. But, believe me, it is no club and it is not small scale. It isn't a ripple effect, it is the big wave. It creates a whole infrastructure that is self-perpetuating, because after graduation, these students know the system and know where and how to buy at bargain prices.

My story is not unique. Last week after learning that I would testify here, messages poured in from ComputerLand dealers in 14 States who face the same dilemma.

One dealer wrote,

> Having been a faculty member at Montana State University, I am a dedicated university supporter, but I strongly resent having a government entity in competition with my retail business.

He cited examples, including these:

> A grocery store owner consults with our staff CPA about an accounting system, taking 20 hours to research to come up with a solution. Then we learned that the owner's wife was a university faculty member. We had to sell at cost or lose the sale. We chose not to sell.
>
> An employee for a national management firm contacts us about buying an IBM Model 50. Her boyfriend is a university student, hence the purchase was made through the university bookstore.
>
> A professor has us provide research on several microcomputers, then thanks us for our help and buys the machine through the university bookstore for his consulting company.

These are everyday occurrences for computer dealers located near universities. Since it takes six to seven sales calls to sell a computer, it is a tremendous loss for us to invest that expertise only to see the customer buy elsewhere.

I believe the mission of the University of Texas is to educate students, not to sell computers. I don't believe the people of Texas intended the university to use its tax-exempt status to compete unfairly against small businesses, which provide 85 percent of the jobs in our State.

Beyond the fact that it is intrinsically wrong, the economic ramifications are vast.

First of all, it undermines local economies. My company employs 43 people with an annual payroll of more than $1 million. When I sell more computers, I create more jobs at no cost to the taxpayer.

Second, there is the cost in tax dollars to subsidize this gray market.

Third, there is the loss of tax dollars. My company pays income taxes, sales taxes, payroll, franchise, property and inventory taxes, just for the privilege of doing business. Every computer sale I lose represents lost tax dollars. Yet I see governments at all levels grappling with huge deficits while subsidizing commercial activities of nonprofit groups.

There is a mistaken belief that these commercial activities are done on a small scale. But an IRS report states that nonprofits get 76 percent of all their income from the sale of products and services.

I am proud to be a small business owner, especially a female business owner—the fastest growing part of small business. In Texas we have more women-owned businesses than any other State except California. So the opportunities for businesswomen have never looked more exciting to me.

Still, running a small business is not the easiest thing in the world. It is about as challenging as running the government.

Small business is one of our country's most important resources. They create more jobs than large businesses.

By their nature, small business people are survivors. All we ask is a level playing field, free of unfair practices.

For computer dealers, I urge this subcommittee to find a solution to the problem of unfair competition, because it has created havoc in our industry that threatens to get worse. Thank you for your attention and consideration.

Whatever standard is eventually adopted for determining whether a nonprofit subsidiary should be taxed as a commercial venture, the standard should: one, contain a clear test to determine when a commercial activity is taxable under the UBIT statute, and, two, be sufficiently flexible to take into account transactions and situations which will certainly evolve in the future.

Many of the problems raised by the NFIB membership could be effectively dealt with by the recommendations in sections A through L of section 1 of the discussion document, with some modifications being necessary.

Thank you.

Chairman PICKLE. Thank you, Ms. Thompson.

[The statement of Ms. Thompson follows:]

NFIB

National Federation of
Independent Business

STATEMENT OF
CAROL THOMPSON, PRESIDENT
COMPUTERLAND, AUSTIN, TEXAS

REPRESENTING THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	House Ways and Means Committee, Subcommittee on Oversight
Subject:	Discussion Options Relating to the Unrelated Business Income Tax
Date:	May 9, 1988

On behalf of the more than 500,000 business owners who are members of the National Federation of Independent Business (NFIB), I wish to thank you for the opportunity to appear before you today to comment on the discussion options relating to the Unrelated Business Income Tax (UBIT).

Last June this subcommittee began an examination of the tax code sections and the Unrelated Business Income Tax rules. It was a courageous act. Conducting hearings to determine whether the UBIT statute fairly taxes non-profit organizations was instantly portrayed by the non-profit community as an attack upon non-profits and those who benefit from their charitable activities.

However, after five days of hearings, even the more skeptical members of the subcommittee became convinced that there is a vagueness in UBIT rules which allows well-meaning non-profit organizations to compete unfairly with small business owners.

NFIB wishes to congratulate the members of the subcommittee and its staff for the prompt and thorough manner in which this issue has been addressed. The draft recommendations are a recognition that some form of a commerciality standard is necessary.

We fully realize that modifications to the discussion draft may be necessary as the subcommittee's deliberations continue, and we stand ready to work with you on areas that may need revision. One modification must be a test of commerciality based on a standard which is clearer than the substantially-related standard in current law. Otherwise, the problems exposed in the hearings will simply return in the future.

Suite 700
600 Maryland Ave. S.W.
Washington, DC 20024
(202) 554-9000

The Guardian of
Small Business

Specific Comments:

The "Substantially Related" Test

The draft discussion document offers three options for dealing with the current test for a substantially-related activity. They are:

1. repeal the "substantially-related " test and replace it with a "directly-related test";
2. determine whether each income-producing activity standing alone is tax exempt;
3. retain the "substantially related" test, but impose UBIT on specified activities whose nature and scope are inherently commercial.

The current "substantially-related" test and its broad judicial interpretations are in large measure responsible for much of the uncertainty which exists in the non-profit statutes and have resulted in the large number of commercial activities of non-profits. Imposition of a modified substantially-related test, a directly-related test, or a straight, stand alone income-producing standard each has a distinct advantage in solving the problem.

Whatever standard is eventually adopted for determining whether a non-profit subsidiary should be taxed as a commercial venture, the standard should:

1. contain a clear test to determine when a commercial activity is taxable under the UBIT statute;
2. be sufficiently flexible to take into account transactions and situations which will certainly evolve in the future.

Many of the problems raised by the NFIB membership could be effectively dealt with by the recommendations in sections A-L of section 1 of the discussion document, with only some slight modifications being necessary.

However, combining the option of these specific industry modifications with retention of the "substantially-related" test in all other cases leaves a lot of open questions.

The current statutory standard used as the basis for determining whether an activity meets the substantially-related test does not require that the activities of the non-profit parent be analyzed in an aggregate manner so that a determination of relatedness can be made based on all activities of the parent.

A substantial part of the problem will remain unresolved if non-profit organizations can simply make a slight adjustment to their current methods of operations to once again come under the mantle of a non-profit organization for all of their commercial activities. Past Congressional attempts to limit the commercial ventures of tax-exempt organizations failed; Congress attempted to impose clearer definitions, and the non-profit community used these new definitions to become even bolder in their ventures.

Over the last twenty years, the non-profit community has illustrated how successful it has become at operating commercial ventures. We believe that in the absence of a tighter, more effective standard of commerciality, the non-profit community will simply adjust its commercial operations to non-taxable, non-profit activities. Therefore, we strongly urge the subcommittee to be very clear in its definition of a commercial test in non-profit operations.

Forty years of judicial test cases have proven that the substantially-related test does not work. To allow it to remain as the final standard, or to replace it with a standard just as weak, would not be an appropriate and effective answer.

Non-profit organizations have been allowed the benefit of the doubt by the tax code and the courts. Their activities have been judged to be substantially related and non-taxable unless the non-profit volunteers to pay taxes on some of its earnings. Even if it volunteers some part of its revenues as taxable, the UBIT statute allows the non-profit other substantial advantages, so that its ultimate taxable income is not consequential.

Perhaps a concept can be integrated in the relatedness test which would result in a two-tier standard. Above a specific level of commercial activity, a non-profit organization would be required to submit data aggregating all subsidiaries and related entities. Whether this standard is based on dollar volume or percentage of income from business activities will require further analysis.

Naturally, the small business community would be most enthusiastic about a clearly defined standard of commerciality for the non-profit community which requires the non-profit to pre-qualify each commercial activity for non-profit status and an exemption from UBIT rules.

From the outset, we have stated that it is not the threat of competition which concerns small business owners. For small business, competition is a fact of everyday life. Our concern is unfair competition arising from the special privileges and unique status non-profits enjoy.

While taxes are one issue of concern, captive referrals and predatory marketing techniques are also serious considerations. For example, many non-profit hospitals establish for-profit subsidiaries to sell or rent various services or pieces of equipment to the community. The great need for funds by non-profit hospitals has led them to venture into the business community as competitors.

They begin their business by signing notes backed by the full faith of the non-profit parent, providing them with substantial access to funds. Subsequently the hospital staff is instructed or requested to refer all patients to these subsidiaries, ignoring any suppliers in the private sector.

An entrepreneur decides to begin a business venture only after having done some preliminary marketing analysis to determine that a market for the product or service exists and to review the current competition. It is not necessary for the non-profit parent to do the same kind of analysis; the non-profit can in effect create the demands for the product or service by diverting all referrals to its own subsidiary.

When a small business owner goes to a bank to borrow money for a business venture, market and competition factors are key to determining the credit worthiness of the business. However, when a non-profit parent of some size guarantees the notes, business considerations are set aside.

An NFIB member provided a recent example of an unfair situation with local non-profit hospitals. This member maintains a health and fitness center with the most up-to-date equipment and monitoring facilities. Recently three local non-profit hospitals established wellness centers. These centers were originally designed to serve patients with cardiovascular problems. However, these facilities now have grown into complete fitness centers providing the same type of exercise equipment as the local small business. Additionally, they are selling general memberships at prices our member cannot possibly match or better.

Last year during the first round of UBIT hearings, NFIB supplied the subcommittee with a specific list of problems and examples from our members. We are once again contacting our membership for additional examples of unfair competition and for comments on the subcommittee's options. We will provide the subcommittee with these examples and comments when they are received.

Subsidiaries and Joint Ventures

Many non-profit organizations use their financial base, strength, and community standing to establish subsidiary firms through which they funnel business. The non-profit will then try to influence its professional affiliates to use the subsidiary.

A standard must be devised under which new subsidiaries must be capitalized, financed, and operated at arms' length, as third-party organizations. Once again, however, the standard must be such that the non-profit organizations cannot simply evade their responsibility by shifting ownership among friends.

As in closely-held family businesses, attribution ownership rules must apply in a manner which prevents subterfuge by the owners to attain tax benefits they would not otherwise be entitled to.

IRS Administration

Without some kind of reporting requirements which require disclosure of the financial details of each subsidiary, IRS or any other agency will not be able to enforce standards. Currently no such requirement exists, and the non-profit is only responsible insofar as it has any financial accountability. Even a certified audit is no guarantee that the UBIT standards are being met: the auditor will interpret the standard to meet the best interests of the client, not the IRS.

Many state legislatures are becoming increasingly interested in the activities of non-profit organizations. However, their resources are even more severely limited than those of the IRS. The members of the subcommittee should understand that whatever decisions they make will affect the states' ability to tax as well. Most states have left the administration of the UBIT to the IRS under the mistaken impression that the IRS was keeping a close watch on non-profit activities.

For any reform to be successful, the IRS must be in a position to know which entities are related to a non-profit. Expanded reporting rules are necessary to require that a non-profit identify those organizations in which it has an interest. The owner of a small business must identify any organization in which it has a 50% or greater interest; these rules should also be applied to non-profits.

Allocation Rules--Passive vs. Active Income

One of the discussion options would require segregation of profit-making activities, similar to the passive loss rules enacted under tax reform. This rule would prevent one loss subsidiary from offsetting losses against a profitable one. Essentially, this recommendation would instill some economic concerns in the management of the non-profit parent. This option is one which should be given serious consideration.

Conclusion

We encourage the subcommittee to continue its deliberations to come up with a clearly defined, easily enforced commercial standard for the activities of non-profit organizations. We believe the subcommittee is going in the right direction with its first proposals, and we look forward to continuing to work with the subcommittee on specific language to take care of the problems and situations highlighted in the discussion draft.

0325T

Chairman PICKLE. Dr. Heyssel.

STATEMENT OF ROBERT M. HEYSSEL, M.D., PRESIDENT AND CHIEF EXECUTIVE OFFICER, JOHNS HOPKINS HEALTH SYSTEM, REPRESENTING THE ASSOCIATION OF AMERICAN MEDICAL COLLEGES, ACCOMPANIED BY ROBERT R. NEALE, VICE PRESIDENT, GOVERNMENT RELATIONS

Dr. HEYSSEL. Thank you for the opportunity to be here today representing the Association of American Medical Colleges and the Johns Hopkins Health System in Baltimore, MD.

I reviewed the testimony of the American Hospital Association before the committee in June and the testimony today, and in general we find ourselves in agreement with that.

I would note also that the contemporary nature of the health care scene in which we are operating has made these difficult times for hospitals generally, and particularly for hospitals which have multiple missions, which include education, research, and often a sizable mission and obligation to care for the poor and those who are not insured.

There has been a large growth of managed health care services such as HMO's. We have in the past in general paid for services such as indigent care and medical educations by cross-subsidies. This gets to be increasingly difficult and it gets increasingly difficult to meet our mission.

I want to underline something said earlier by the representative of the American Hospital Association, that we take our mission seriously. We were charged with being involved in education and research at our founding, and taking care of the poor. That is our mission and that is what we will do.

That has necessitated a different kind of organization and reorganization, joining together into now what is a four-hospital system in our case, along with an HMO—steps we would not have been interested in less than a decade ago.

We are in the midst of a remarkable change. Like many institutions organized as not-for-profit institutions, we do have a for-profit subsidiary.

I want to underline our willingness to answer questions about that, but to say that we have had three tests for getting into such enterprises: one, to reduce our own costs, making us better able to compete; second, to insure the quality of the services; and, three, to add revenues to support our other missions. So we are not in other businesses simply to make a profit, to compete, if you will, because that is more fun than the hospital business. We are into those activities to support our overall mission over the next number of years.

We believe that the current tax law has achieved a certain clarity through the IRS rulings related to related business activity.

I would simply say that we pay taxes on any unrelated income and we are perfectly willing to do it. We believe, however, that the current law serves our purposes and the purposes of the Federal Government quite well.

I again thank you for this opportunity.

Chairman PICKLE. Thank you, Dr. Heyssel.

[The prepared statements follows:]

STATEMENT ROBERT HEYSSEL, M.D., ASSOCIATION OF AMERICAN MEDICAL COLLEGES

Mr. Chairman and Members of the Subcommittee, my name is Robert Heyssel, M.D. I am President of the Johns Hopkins Health System in Baltimore, Maryland. I am pleased to come before you today to discuss your Subcommittee's proposed options for change in the laws governing the unrelated business income tax.

Mr. Chairman, I have reviewed the testimony of the hospital witnesses that appeared before your Subcommittee during the June hearings on this subject, and have concluded that there is not much I can add about the relationship of the present UBIT laws to the activities of non-profit hospitals. But, because the Johns Hopkins Hospital has recently become the Johns Hopkins Health System, it might be useful to you and the members of the Subcommittee for me to make myself available to you for questions about our present corporate organization. I have attached an organizational chart of the Johns Hopkins Health System. The range of services provided by this new and emerging organization characterizes a broad, full-service, integrated health system that has major research and educational goals as well as patient care responsibilities.

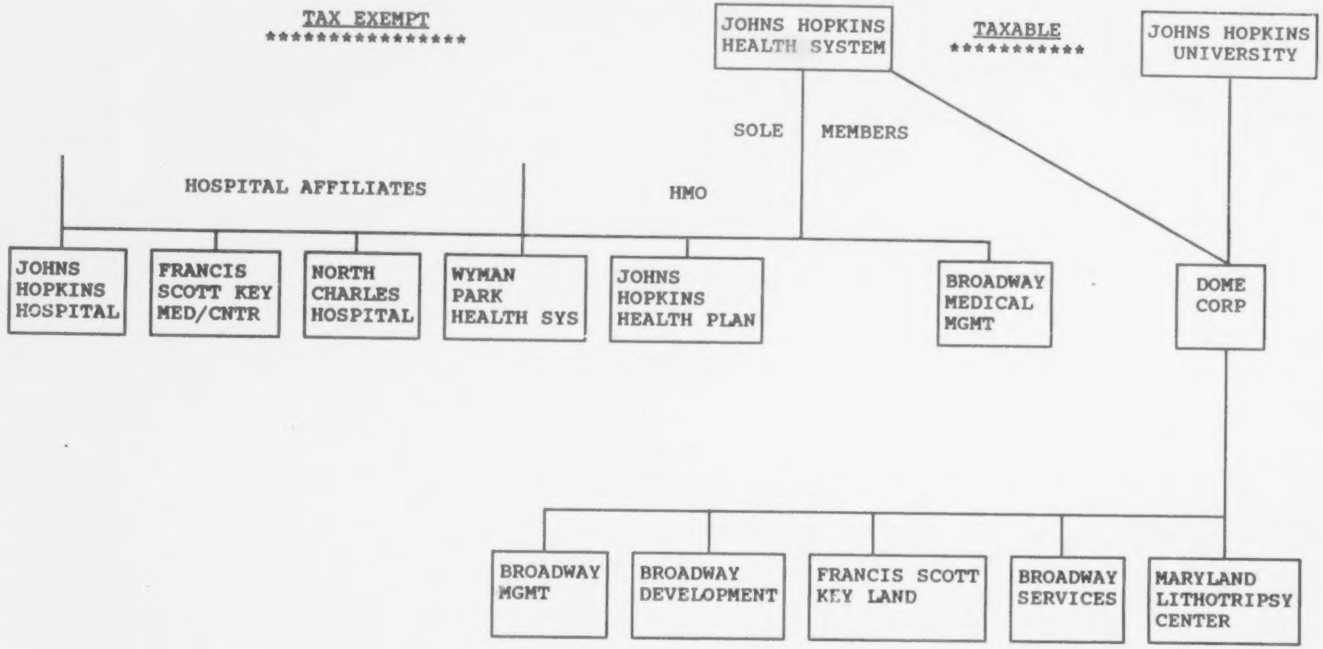
Some preliminary observations about the contemporary nature of the health care environment in which we are operating will set the scene for my responses to your questions. Concomitant with the introduction of the Medicare prospective payment system, a number of other factors have emerged to create a growing price competitive and price sensitive environment. Central has been the growth of large scale purchasers of hospital services. These organizations may be HMOs or alternative delivery systems of various types as well as self-insured employers. Our future financial viability is dependent upon our ability to price our services competitively. At the same time we must serve those in our community who cannot afford to pay for health care services. And we must do so while serving our research and education missions as well.

Our problem is best understood in the context of the notion of cost-shifting. Classically, this has been the method of financing care of indigent patients, namely by charging higher prices to those who can pay to make up for those who cannot. Essentially we have served one group of patients at the expense of another. In other contexts this has been referred to as cross-subsidy financing. For example, because of our involvement in research and in education, there are added costs that accrue to our environment. These costs must also be borne. Thus we are not in a good position to meet the competition on the basis of price in the provision of routine hospital and medical services. We are constantly in a search for new revenues and ways to reduce our cost of doing business.

Let me be clear; we are not in a position to pick and choose those services in which we wish to be involved. We need to be a full-service operation. Like the United State Post Office, we are vulnerable to those who, like Federal Express, can find a profitable segment in which they can beat our charges which are set to support unprofitable but essential services. We must maintain a commitment to the full range of services so that we can provide a proper setting for education and an environment conducive to research. Our organizational strategies for dealing with the new realities of the new competitive market are designed to permit us to meet our educational and research obligations and other eleemosynary commitments in the community. The attached organizational chart represents the organization we have put into place to achieve these objectives. It reflects the best available advice from tax and other corporate attorneys on ways to meet our objectives within the framework of current tax laws and policies governing reimbursement for our services. The current tax law has achieved a certain clarity through IRS rulings and court decisions which provided guidance for our decisions. To substitute new and undefined standards such as "directly related" for the now defined and perfectly serviceable standard of "substantially related" is to invite tremendously expensive and unproductive re-litigation of well settled issues. I urge you to proceed with great caution.

Our corporate strategy to respond to this new competitive environment has been regarded by some as very aggressive, but I believe necessary and appropriate for fulfilling our mission in the current environment. Therefore, I am pleased to have the opportunity to respond to questions regarding the impact of the proposed changes in the UBIT laws. Thank you for the opportunity to appear before you this morning.

THE JOHNS HOPKINS HEALTH SYSTEM ORGANIZATIONAL CHART


TAX EXEMPT
JOHNS HOPKINS HEALTH SYSTEM
TAXABLE
JOHNS HOPKINS UNIVERSITY
SOLE MEMBERS
HOSPITAL AFFILIATES
HMO
JOHNS HOPKINS HOSPITAL
FRANCIS SCOTT KEY MED/CNTR
NORTH CHARLES HOSPITAL
WYMAN PARK HEALTH SYS
JOHNS HOPKINS HEALTH PLAN
BROADWAY MEDICAL MGMT
DOME CORP
BROADWAY MGMT
BROADWAY DEVELOPMENT
FRANCIS SCOTT KEY LAND
BROADWAY SERVICES
MARYLAND LITHOTRIPSY CENTER

Chairman PICKLE. Mr. Parks.

STATEMENT OF HAWORTH H. PARKS, SR., CHAIRMAN OF THE BOARD, HEALTH INDUSTRY DISTRIBUTORS ASSOCIATION, ACCOMPANIED BY PAUL SIMMONS

Mr. PARKS. Mr. Chairman, it seems I am surrounded by potential customers. I had better be careful.

I am Haworth Parks. With me today is Paul Simmons, no stranger to this committee, as he has testified before. I am also president of my own company in Nashville, TN, which has experienced unfair competition from the not-for-profit hospital sectors.

We are delighted to see the progress your committee is making in this very important area. Indeed, your action may prove the salvation of the private health care distribution industry. It doesn't take a very smart person to figure out that a profit structure cannot compete with a nonprofit hospital in the medical supplies market if the hospital is basing its resale prices on wholesale costs far below those the traditional distributor has to pay for the same merchandise.

Nor can that traditional distributor compete when the hospital is also taking advantage of other nonprofit institution edges, like the tax-free accumulation of its operating capital, the Hill-Burton financing of its facilities, the ability to subsidize personnel or other startup costs out of hospital-paid personnel or subsidized rent, and in some cases the use of buildings and even parking lots exempt from local property taxes and other costs incurred by private sector distributors.

Our members time and time again encounter hospital personnel acting as salesmen and managers of these subsidiary operations, whether these subsidiaries are labeled "for profit" or "not for profit."

In sum, the kinds of situations we are seeing out there are not only depriving the Federal, State, and local governments of revenues, but are also weakening, even destroying private firms.

As the subcommittee well knows through previous testimony, HIDA is not alone in its concern over this phenomenon. Any time a nonprofit hospital enters into competition with the private sector, whether it be in selling medical supplies, drugs, laundry services, catering services, even transportation services, someone in the private sector suffers. So does the taxpayer.

Earlier in the 100th Congress, you acted to absolutely ban the resale of drugs for many of the same reasons at issue in this hearing, plus for reasons relating to the integrity of the recall system for tainted or defective drugs.

HIDA strongly supports the idea of a parallel ban on nonprofit hospital resales of any medical devices or supplies, not only because such resales are anticompetitive and often illegal, but also because such resales undermine the very effective recall system that has evolved over the years that can get defective, dangerous products off the market in a matter of days.

Short of such a universal ban, the Congress should at least adopt several of the proposals under consideration in these hearings.

First, we endorse the idea of repealing the so-called substantially related test to be replaced with a directly related test. In effect, this would ensure that each and every single activity of the nonprofit institution is looked at for what its purpose actually is. Is it to provide direct care for an in-hospital patient? Fine, then it is tax exempt. Is it for any other purpose? If so, it should be taxed just as any private business is taxed, period. In short, any nonprofit hospital activity competing with the private sector should be taxed from the first dollar.

Second, we support the idea that any nonprofit health care organization which obtains any of its revenues from non-patient-care activities should lose its tax-exempt status. This should be especially enforced when a nonprofit hospital takes advantage of its unique antitrust exemption to buy medical products under discriminatory deep discounts and resell them to any other providers, including the gray market underground that is undermining the distribution system. There must be a very tough punitive consequence for such behavior if it is to be curbed. The most logical remedy would be the loss of a hospital's Nonprofit Institutions Act exemption or even of its nonprofit status altogether.

Third, revenues from sales or rental of medical equipment or supplies to outpatients or persons not patients of the hospital should be subject to the UBIT. In addition, laws and regulations should be tightened to ensure taxes are not evaded on such sales by shifting costs to a for-profit subsidiary when actually incurred by the nonprofit parent. Any affiliated for-profit activity should be totally separated from the nonprofit parent. Subsidized personnel and the use of tax-free capital should be ended.

Let me conclude by saying I am sympathetic to the plight of the nonprofit hospitals. After all, they are our customers, too.

Having been in this business for almost 40 years, I am personally aware of many outstanding board members and top hospital administration officials who perhaps don't understand the dynamics, or the dangers, of what is happening within their hospitals. Virtually none of these people would condone such activities if they fully understood the consequences.

Finally, I would herald the day when every actor in the industry is returned to his or her proper role, when the manufacturer is manufacturing, the distributor distributing, the hospital caring for patients and nothing more—in short, with all playing on a level field and none trying to exploit any other through an unfair advantage.

We, as distributors, have no fear of full and fair competition. We have been doing it successfully for more than 100 years. All we ask is that we be allowed to continue to compete and that the excess costs to the health care community and the patients it serves caused by the kind of activity by nonprofit institutions at issue in this hearing be stopped.

Then I wouldn't have the need to be here testifying on such issues today.

Chairman PICKLE. Thank you.

[The statement of Mr. Parks follows:]

HIDA
HEALTH INDUSTRY
DISTRIBUTORS
ASSOCIATION

National Headquarters—1701 Pennsylvania Ave., N.W. Suite 470
Washington, D.C. 20006 202-659-0050
Government Relations Office—1101 Connecticut Ave., N.W. Suite 700
Washington, D.C. 20036 202-857-1100
Trade Show Office—111 East Wacker Drive, Suite 600
Chicago, IL 60601 312-644-6610

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CONTACT PAUL B. SIMMONS
(202) 659-0050

STATEMENT BY
HAWORTH H. PARKS, SR.
CHAIRMAN
HEALTH INDUSTRY DISTRIBUTORS ASSOCIATION

HEARINGS OF THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON THE UNRELATED BUSINESS INCOME TAX

MAY 9, 1988

Mr. Chairman, Members of the Committee:

I am Haworth H. Parks, Chairman of the Health Industry Distributors Association, headquartered in Washington, D.C.

First, let me say I appreciate this second opportunity to present our organization's views on this issue.

As you know, our former president, Paul B. Simmons, who has had a long relationship with this Committee, testified on our behalf nearly a year ago at your June 26, 1987 initial hearings on this subject.

To save time and to permit me to concentrate on the particular issues this Subcommittee has raised since those hearings, I request your permission to resubmit excerpts from that testimony for the record of these new hearings. It provides much of the background underlying HIDA's concerns on the very troublesome issue of non-profit hospital competition with for-profit businesses such as those operated by the 450 corporate members of HIDA and sets the stage for the brief comments I want to make today.

In 1938, as you know, non-profit hospitals were originally granted special product purchasing privileges under the Non-Profit Institutions Act in light of their eleemosynary role providing charity care for the poor.

But these privileges were in no way intended by the Congress to permit such hospitals to compete with private firms in areas other than institutional care.

Today, too many of these hospitals are buying and re-selling products in general competition with private firms. As a result, they are draining tax dollars out of our economy and abusing special non-profit privileges in order to exploit expansionist forays into areas far removed from their mandate of in-hospital patient care.

As HIDA pointed out in its June 26 testimony last year, non-profit hospitals often enjoy access to below-market prices for medical equipment and supplies because of their blanket exemption from the Robinson-Patman Act under the Non-Profit Institutions act. Of course, this exemption is supposed to be limited to cover those goods purchased by the hospitals "for their own use" and thus should exclude them from re-selling such discounted products to anyone else.

However, this stricture is often ignored by hospitals in their desire to make profits or to bind more tightly to them their referring physicians. This is done, typically, through the device of offering to sell medical equipment and supplies to favored doctors at prices below those available through traditional distributors. Such distributors, of course, do not share the hospitals' privilege to buy such products at deep discounts under the Non-Profit Institutions Act exemption to the Robinson-Patman Act.

It doesn't take a genius to figure out that a traditional distributor simply can't compete with a non-profit hospital in the medical supplies market if the hospital is basing its re-sale prices on wholesale costs far below those the traditional distributor has to pay for the same merchandise.

Nor can that traditional distributor compete when the hospital is also taking advantage of other non-profit institution edges like the tax-free accumulation of its operating capital, the Hill-Burton financing of its facilities; the ability to subsidize personnel or other start-up costs out of hospital-paid personnel or subsidized rent; and, in some cases, the use of buildings and even parking lots exempt from local property taxes and other costs incurred by private sector distributors. Our members time and again encounter hospital personnel acting as salesmen and managers of these subsidiary operations--whether these subsidiaries are labeled "for profit" or "not for profit."

In sum, the kinds of situations we're seeing out there are not only depriving the Federal, State and local governments of revenues, but are also weakening, even destroying private firms.

As the Subcommittee well knows through previous testimony, HIDA is not alone in its concern over this phenomenon. Any time a non-profit hospital enters into competition with the private sector, whether it be in selling medical supplies, drugs, laundry services, catering services -- even transportation services -- someone in the private sector suffers. So does the taxpayer.

Earlier in the 100th Congress, you acted to absolutely ban the re-sale of drugs for many of the same reasons at issue in this hearing -- plus for reasons relating to the integrity of the recall system for tainted or defective drugs.

HIDA strongly supports the idea of a parallel ban on non-profit hospital resales of any medical devices or supplies, not only because such resales are anti-competitive, but also because such resales undermine the very effective recall system that has evolved over the years that can get defective, dangerous products off the market in a matter of days.

Short of such a universal ban, the Congress should at least adopt several of the proposals under consideration in these hearings.

First, we endorse the idea of repealing the so-called "substantially-related" test to be replaced with a "directly-related" test. In effect, this would ensure that each and every single activity of the non-profit institution is looked at for what its purpose actually is. Is it to provide direct care for an in-hospital patient? Fine, then it's tax exempt. Is it for any other purpose? If so, it should be taxed just as any private business is taxed, period.

Second, we support the idea that any non-profit health care organization which obtains more than five per cent of its revenues from non-patient-care activities should lose its tax-exempt status. Similarly, any affiliated for-profit activity should be totally separated from the non-profit parent. Subsidized personnel and the use of tax-free captial should be ended.

Third, revenues from sales or rental of medical equipment or supplies to out-patients or persons not patients of the hospital should be subject to the UBIT. In addition, laws and regulations should be tightened to ensure taxes are not evaded on such sales by shifting costs to a for-profit subsidiary when actually incurred by the non-profit parent.

Chairman PICKLE. First I want to ask Ms. Thompson, this morning we commented about the recommendations that the committee advanced as a discussion option with respect to the sales of computers from bookstores at the university campus or near the campus. It was our feeling that we ought to limit it to educational pursuits and that they would not be entitled to more than one computer per year.

The Treasury testified this morning that that was too many computers and no one student could really use a new computer every year, and we ought to limit that number. He did not say whether it was 1, 2, 3 or 4.

Do you think we should limit them to one computer or could they have as many as four? Does that bother you?

Ms. THOMPSON. Yes. I think they could use one computer for the duration of their college career. Computers last.

Chairman PICKLE. Computers change probably as fast as any type of business machine we have today. The computers we are using today in our offices were not in existence 4 years ago.

If we just say you can only have one in 4 years, is that limiting the student or faculty too narrowly?

Ms. THOMPSON. Most of them use it for word processing, and for that use it will last 4 years. I think they should have a way to turn it back in when they get the new one.

At the University of Texas, you sign a piece of paper saying you will keep it for the year and not sell it, but that is not being policed.

Chairman PICKLE. You endorse the limitation on equipment of that type?

Ms. THOMPSON. That is correct. Where we are, they only get one a year. I listened to other testimony and evidently other universities let them get more than one a year.

Chairman PICKLE. You want a limitation on the specific number?

Ms. THOMPSON. That is correct.

Chairman PICKLE. Now, Monsignor, you said the changes we make in the law could not come at a worse time, I think you said, for hospitals.

Reverend McGOWAN. We always say that, Mr. Chairman.

Chairman PICKLE. I don't know that we can relate that necessarily to the changes we are considering now, and all that you say may be true. The fact of the matter is that we are trying to determine what is related. I don't see personally that we have made as many changes as we have indicated.

You said in your testimony that the sale of pharmaceuticals or off-the-street tests or medicine—that they ought to pay taxes. Yet evidence shows that many of the hospitals do not make a differentiation in prices.

In what way are we making radical changes?

Reverend McGOWAN. I was referring to the options, not things you were going to change, and I was indicating that they had no indication because we had no indication of what those words would mean.

Chairman PICKLE. You do not object to the general approach of the committee's discussion options, that is, if it is a pharmacy in a hospital, if they just sell it to the public as a whole——

Reverend **McGowan**. We have no problem. If the pharmacy is used for people who are not patients, clearly taxes should be paid under UBIT.

We make an effort to keep track of who is and who is not a patient. Our history shows we do charge the patients of doctors.

Chairman **Pickle**. You are doing that now?

Reverend **McGowan**. I hope so, Mr. Chairman.

Chairman **Pickle**. Then I don't know that we are proposing anything in our options that is really a radical change or different from what we practiced in the past, as I see it. We may be closer together than you think on our views.

Reverend **McGowan**. I understand the purpose of your committee and you are accomplishing a great deal by alerting us to the responsibilities.

Maybe some organizations have been slow in making those reports, but we recognize that a change in wording could be very dangerous because it seems not to have the sensitivity to our move to outpatient and home health care. We think that is part of our mission.

Chairman **Pickle**. Do any of you people who have testified want to make an additional statement based on what other witnesses have said today?

Mr. **Parks**. You have been asking which of the options troubled the prior witnesses most. Ours would be B and H.

Chairman **Pickle**. All right. So B bothers you more?

Mr. **Parks**. B and H, yes.

Chairman **Pickle**. Did anybody else have a special hurt?

Dr. **Heyssel**. I would like to comment about the definition of what a hospital does, and some of the options and some of the statements are fairly narrow when we limit things to inpatients alone when we talk in terms of what we can sell.

The point was made earlier that hospitals have become a fairly full provider of health and medical services, and the outpatient area is being emphasized. What is called a continuous care patient is confusing the term that we have not defined in the past.

Chairman **Pickle**. I don't know what we can do about the definition, but I appreciate your comment on that.

I don't know if I have any other questions.

Mr. Thomas.

Mr. **Thomas**. Thank you, Mr. Chairman.

Dr. Heyssel, are we running into problems in trying to define what a patient is nowadays?

Dr. **Heyssel**. A patient is someone who needs medical services, whether in a bed or an outpatient.

Mr. **Thomas**. If I were in a hospital and had been serviced by a hospital, I am a patient. I am made well, I leave, I am discharged, I pay my bill. I come back for a prescription drug. I have had an affiliation with the hospital. Am I still a patient?

Dr. **Heyssel**. If you were a registered patient in our outpatient department, you could at one time have gotten your prescription drug from our outpatient pharmacy. I will come back to that. We don't operate one any further.

But you could not walk in off the street, not having a prior relationship to the institution.

My definition is someone under the auspices of the hospital, receiving their medical care.

Mr. THOMAS. Today is the former situation still true, that having been on your books once, I am still on the books?

Dr. HEYSSEL. We are not operating an outpatient pharmacy at this point.

Mr. THOMAS. You say the function is, one, to reduce costs; two, for better services, I suppose to offer more services; and, thirdly, revenue.

Say I am an outpatient and I want to buy something that has not necessarily been prescribed to me, a piece of medical equipment. Can I buy that, under the patient nomenclature, for a price that is very competitive or lower than if I walked into a medical supply store?

Dr. HEYSSEL. We don't have a medical supply store at Johns Hopkins. Normally you would be referred by your physician or whoever you happen to be related to, to another supplier of medical equipment.

We do, through a subsidiary, sell durable medical equipment, but that is a joint venture with another company.

Mr. THOMAS. So that would not enter into the discussion.

Dr. HEYSSEL. I guess part of my problem is that we may be getting at laws on the books that don't necessarily pertain to taxes.

Mr. Thomas, I believe the Robertson-Patman Act was something you were concerned about. Unfortunately we were not looking at the legislation in terms of using it for your own use or not selling it as a passthrough operation. I think it is far more complicated than just the taxes. I don't know how many people wind up getting packages with various statements on them which allow you to use it for some period of time, even after you have left the hospital, and doctors supply those as well.

Mr. THOMAS. Ms. Thompson, I buy a Mac 512 as a freshman.

I use it for word processing and I can handle that without any problem. As I become a sophomore and junior and pick up more sophisticated software, more often now it requires you have one megabyte of memory to use it.

Ms. THOMPSON. I don't have any problem with that.

Mr. THOMAS. Then I find out I would like to have a hardware disk built in and my old 512 is no longer available from Apple; they have upgraded them significantly.

How can you say, if I bought a computer as a freshman, that I am supposed to keep it for 4 years? Would you tell your customers, if you buy this you have to keep it for 4 years?

Ms. THOMPSON. We allow our customers to trade in and trade up.

Mr. THOMAS. Would you allow the students to do that?

Ms. THOMPSON. Correct.

Mr. THOMAS. Would you allow them to sell it in order to trade up or would the bookstore have to turn into a used computer store, as well?

Ms. THOMPSON. Would I?

Mr. THOMAS. We have the student with the computer that is inadequate in his terms.

Ms. THOMPSON. I would like the student to buy from me.

Mr. THOMAS. Would you allow the bookstore to sell the computer?

Ms. THOMPSON. If they are competing with me on the same prices.

Mr. THOMAS. If there is another store that competes with you, would you want them to go out of business?

Ms. THOMPSON. No. We all buy at the same price.

Mr. THOMAS. Why can't they sell it if they buy it at a lower price, if it is directly related to educational uses?

Ms. THOMPSON. I feel like the university is there to educate and the retail computer store should sell the computers at an educational price.

Mr. THOMAS. Can the bookstore sell paper and pencils or should that be done at an educational retail store?

Ms. THOMPSON. They can sell it. I think the computer is one of the few things sold at below the street price.

Mr. THOMAS. Oftentimes the bookstores try to be reasonable and sell things at very low markup and they make it on other items. If your argument is that they should sell them for what other people are selling them for——

Ms. THOMPSON. They sell at below street price.

Mr. THOMAS. Then why do you complain?

Ms. THOMPSON. If they paid taxes, that would be fine.

Mr. THOMAS. Why do they have to pay taxes? Isn't the computer related to the educational function of the university?

Ms. THOMPSON. I think they have plenty of computers.

Mr. THOMAS. If the student wants to use it for educational uses, you don't think they should be able to sell it?

Ms. THOMPSON. Right.

Mr. THOMAS. Or they should pay taxes on it?

Ms. THOMPSON. Right.

Mr. THOMAS. That is also true with paper and pencils?

Ms. THOMPSON. They sell them at street price.

Mr. THOMAS. How about books?

Ms. THOMPSON. I am really only discussing computers, unless you are asking me about my opinion.

Mr. THOMAS. How about software on a disk? That should be at retail price and they should pay tax on it?

Ms. THOMPSON. They do that.

Mr. THOMAS. But they should pay taxes on it?

Ms. THOMPSON. That is right.

Mr. THOMAS. You don't think they should be able to provide anything unless they pay taxes on it—maybe textbooks; is that correct?

Ms. THOMPSON. Right, that is correct.

Mr. THOMAS. So pencils are the only things the bookstore should be able to offer. If the school teaches a course in photography, they have to offer film at street price?

Ms. THOMPSON. They do offer it at street price.

Mr. THOMAS. My problem here is in repeat sales. I would like to set up a procedure where the ID is punched and, if they do sell it, they have to bring in a sales receipt. But there is a lot of difference between where I want to move from in current law and where you want to move. I don't think we are going to get where you want to go, and I don't know that we should.

Chairman PICKLE. Will you yield?

Mr. THOMAS. Certainly.

Chairman PICKLE. I don't think we are talking about taxing every item in a bookstore. There is a certain de minimus figure that would be allowed.

My question had to do with a bookstore. If you take it to every item sold in the bookstore, that would be hard.

Mr. THOMAS. It is not narrowly or directly related to its primary purpose, and that is why they are allowed to do what they are doing.

We are saying now that there is a dollar factor involved which separates it, rather than the use of the tool. I cannot buy that concept. To me, the dollar amount is not relevant; it is whether or not they are directly related.

The problem is, do individuals abuse the ability under that structure. I wanted to see how far she was willing to go in related materials in defense of her computers.

Ms. THOMPSON. You did it.

Mr. THOMAS. I want you to appreciate a little bit what we are going through.

Ms. THOMPSON. My major problem is the sell-through to the market, which is a significant factor to people like me.

Mr. THOMAS. I agree with you. We have to figure out how, suggesting when you buy a 512 Mac as a freshman, to say, sorry, kid, but you have to keep it for 4 years, you should have bought more memory.

Those suggestions are not going to work. We have to be far more sophisticated. Unless you talk about something being directly related and standing alone absent other combinations to the activity that they are carrying out, you get into all kinds of bizarre cul de sacs.

You run into the problem of how they define a patient, the idea that medical things ought to be sold off site versus on site, and some people will say they are all sold off site. There are some folks who fundamentally and philosophically are fairly close to where you are. I don't believe that everything ought to be taxed. I believe you can make an argument which is substantial enough that within a narrow purview it would not be subject to unrelated business taxes.

Our problem is that people are so clever, and the pressures are so great, that I would suggest that even Dr. Heyssel, when they sit around and talk about one, two and three, they don't always fall in that order when they are discussed. Once in a while someone will commit heresy by talking about three, revenue factors, and maybe it is dismissed immediately.

Dr. HEYSSEL. It is dismissed immediately.

Mr. THOMAS. I knew you would say that.

Apparently there are folks who have stepped over the line. How do you redraw the bounds? It is very, very difficult.

The easy answers are not very useful because they don't allow some of the long-time and innovative functions that are being carried out.

So as we go through this process, just appreciate the idea that I understand your complaints in terms of how frustrating it is when somebody uses your services and then goes to buy the computer at the school at a discount.

We appreciate your testimony. I just hope you understand, as we pursue this, that we are doing it with as much sensitivity as we can. And, given these kinds of panels where folks are on opposite sides, if you are doing any talking among yourselves, to give us some examples, it would help very much.

Chairman PICKLE. Now, let me get back to the hospitals.

They have expressed concern about the impact the option we have would aggregate the income and activities of the exempt hospital systems. For purposes of determining the hospital tax-exempt status under the present law, the primary purpose of the exempt organization must be its exempt purpose.

Now, you hospitals, how do you meet that requirement today? Don't you do it through aggregation? How do you meet the tax-exempt provision now with regard to the aggregate question?

Mr. BROMBERG. Under the concept in aggregation, you take taxable subsidiaries which, are taxable because they are engaged in taxable activities, and you put the taxable subsidiaries together with the nontaxable parent and subsidiaries and determine whether the aggregate is or is not taxable. In most cases you will see that the taxable subsidiaries are what they say they are, subsidiaries, and relatively small, compared with inpatient and outpatient and home health care.

I don't know that hospitals are terribly concerned about the concept of aggregation as long as we know what we mean by primary purpose.

Chairman PICKLE. I assume that we are in agreement that the primary purpose of an exempt organization must be its exempt purpose.

How much more difficult would it be if you had that proposed aggregation rule?

Mr. BROMBERG. I don't think it makes a great deal of difference in the health care field. If you have a hospital with $400 million nontaxable revenues and it has a subsidiary grossing a million or half a million a year in some taxable activities—the hospital, I am sure you know, is one of the largest type of employers. You look at the number of employees in a hospital compared with the taxable business. You also look at the expenses and gross income.

When you aggregate them, there is still no doubt that the primary purpose is the rendition of health care. It would take hundreds of taxable subsidiaries before the hospital's basic mission of providing health care—both inpatient and outpatient, through diagnostic care, right through home health care—ever loses that primary purpose.

It is a question of making sure we understand what we mean by aggregate in order to determine primary purpose.

Chairman PICKLE. At what point does the hospital's legal responsibility begin when a person enters the hospital facility for some kind of health care services? Is that the point where a definition of a patient begins?

Mr. BROMBERG. The definition of a patient was established by the IRS in 1968, 20 years ago. They have six categories of patients: inpatients, outpatients, patients referred to diagnostic care or any patients with a hospital-affiliated home health service, affiliated extended care facilities, and also in the context of drug sales, and patients refilling prescriptions they got during their care as hosptital patients.

Basically the difference between 40 or 50 years ago, when the antitrust concerns that were mentioned existed, was that inpatient care was what a hospital did, and today the vast majority of patients are outpatients. In fact, hospitals have to—the U.S. Government is pushing and pushing toward expansion of outpatient care, for the very simple reason that it is much less costly.

Unfortunately what we hear from small business representatives is that the hospital's mission should only be inpatient care and they should be penalized and discouraged from providing outpatient care by taxing everything provided for outpatients.

Chairman PICKLE. You personally would not say that the inpatient definition comes into being the moment you enter the hospital for any services?

Mr. BROMBERG. It is anytime you enter the hospital for any hands-on medical care. If the person comes in for a diagnostic test, or if a hospital has a satellite out patient facility, that would be a hospital patient. An emergency patient, contrary to some suggestions here, would be a hospital patient, even though he does not go into a bed.

The last thing we want to do is encourage a push back toward inpatient care as a substitution for outpatient care. It would have a devastating effect on the cost of health care.

Chairman PICKLE. How do you justify that federal health care policy is pushing you into more hospital services?

Mr. BROMBERG. They are pushing hospitals, and rightfully so, into expanding their non-inpatient care activities, that is their outpatient activities. It is not really a pushing, it is a partnership. The hospitals want it. More today can be done on an outpatient basis.

It is the old concept—back in the 1950's there was a case in Florida, an insurance case, that said only an inpatient is a patient of the hospital. That is obviously not true today. Anyone who has some hands-on physical contact with a hospital in any type of facility—for example, a hospital-sponsored home health care service is a patient. More hospitals are moving into these out patient services. This is the cheapest way to provide that care. Therefore, a person receiving care from a home health service of a hospital is a hospital patient. There is nothing wrong with selling him durable medical equipment, selling him drugs, or taking a specimen from that home health care patient back to the hospital, to its lab. There is nothing wrong with that.

We are not trying to disrupt the system. All we care about is making sure there is competition. There is competition, but there are more nonprofit. There is competition.

Chairman PICKLE. We are trying to determine what is a patient—an inpatient or an outpatient. That line is not clearly established. Apparently you are saying you should not have more time in the hospital because modern medicine has expanded so more outpatient surgery is done.

You say there is no such line; I think you are probably being too liberal.

Mr. BROMBERG. I am not saying there is no line.

Chairman PICKLE. You are saying it is mighty broad.

Mr. BROMBERG. The line is at the point that the hospital provides some form of hands-on care of that person.

The discussion option's statement of present law is wrong. For 20 years now the IRS position, which has been accepted and recognized by the health industry, is that drug sales, for example, a hospital's satellite pharmacy in a medical office building, is an unrelated business. But the IRS also recognizes that drug sales to patients of home health services of a hospital are related.

Chairman PICKLE. I am not trying to argue with you. For 20 years we have done certain things. We are trying to find out what is better.

To date the Treasury and IRS have said these aggregate rules are appropriate. You are saying that the line is so blurred that we don't have to get into that. I don't know that we can accept your point.

Mr. THOMAS. We have a heart patient—Mr. Bromberg—who comes in and signs into the hospital. Open heart surgery is performed on him, a bypass. He recovers hopefully, and becomes an outpatient for a period of time. Obviously, the doctor in the hospital has been counseling that he has a problem with his diet and exercise. Tell me where the line is drawn in terms of the hospital's crossing over?

He was a patient who was operated on. He is an outpatient being counseled. Doesn't it seem appropriate that you can build a facility adjacent to the hospital as a cardiac exercise area in which you can monitor the exercise of this individual and in fact provide him with a number of exercise machines in the routine which is appropriate. If they are there, you might as well make sure, as far as dietary concerns that you have are met with a breakfast, lunch and dinner program, which augments this outpatient or former outpatient.

Now, we started with a fellow who came into the hospital because he was dying, and he got bypass surgery. We now are maintaining a health area with a health food operation. Where does the one begin and the other end?

Mr. BROMBERG. Let me answer that by saying that perhaps I will make the answer simpler. Forget about the fact that he started out as being a heart patient with open heart surgery, and he continues to receive cardiac rehabilitation. Take a person that, because a patient for the first time, because he comes to a cardiac rehabilitation or evaluation center, is examined, and goes through the programs, or his physician sends him to a dietician at the hospital for its program.

I think the answer to the question is that, whenever the activity is one in which there are hospital people involved in hands on care—and care, of course, would include preventive medicine, he is a patient. The reason he is in the cardiac rehab program is that we don't want him to have another heart attack. Surely that is related to a hospital's purposes, and the person is still a patient of the hospital if he is in a rehab program of the hospital. In terms of rehabilitation, he is every bit as much a patient as when he is being operated on.

I don't think you would want the hospital to say, fine, you are well, go home and if you happen to get another heart attack because you have been exercising too strenuously or not at all, then came back the concept is one of continual care. Certainly if that person came back to the hospital because he developed an allergy to shellfish and went to the drugstore of the hospital and tried to buy a pill, that person is not a patient of the hospital for those purposes. No one would argue that point.

But with respect to the hospital, after the person is operated on, the cardiac evaluation and rehabilitation facility is a form of preventive medicine and the person is a patient when he receives that service.

Mr. **Thomas**. So a patient is someone who you say has a hands on application. We don't have any doctors in this cardiac exercise area. We have some folks who were trained in physical therapy and perhaps we can go one step beyond that. There was a fellow very successful in running these exercise machines in a gym and he doesn't really have a medical degree or even a para-professional degree, but he is good at doing what he does.

What I am trying to do is get you to understand that what you have done is run so far a field for me that when you testified earlier that the aggregation problem is no problem at all, because hospitals are so labor intensive and the amount of dollars is so great, what you have basically defined for me is the role of a hospital which can touch everybody in the society for all of their life and still fall under the umbrella as you see the mission.

So I am concerned about that, and I am wondering if you are testifying officially for the American Hospital Association, because in their testimony, they say AHA strongly opposed the aggregation. You say you don't, it is not a problem. Therefore, you would have no problem if we moved the aggregation in as a rule.

Mr. **Bromberg**. We are concerned in terms of aggregation because it is not clear how it would apply or how primary activity would be determined. Aggregation, as far as it has been discussed by the Treasury Department, relates to different corporations being pulled together to determine their primary activity.

AHA feels that if hospitals and some taxable subsidiaries engaged in businesses are pulled together, their primary purpose would still be health care. You are speaking of aggregating activities within an exempt organization. I don't think AHA has any problems there. Most of this will involve some form of health care.

It doesn't mean that a hospital can go out and provide, for example, diagnostic tests for private patients of physicians. We acknowledge that is generally unrelated. But what we also believe is that testing for the hospital's outpatients is a related activity.

Mr. **Thomas**. My problem is, if you begin pushing those points, eventually you get into spinoffs and you begin to move them out, and I believe the chairman's line of questioning was a legitimate one, and a reasonable one. I know you want to give specifics to it. When I heard you say you were not concerned about the aggregation rule, I had difficulty with the official testimony and where you are. If you don't have a concern about it, then, Mr. Chairman, I am clarified on the AHA's position.

Chairman PICKLE. I don't know that I can say what is meant by continued-care outpatient. I don't know that you can, or the American Hospital Association can explain the concept. It is a phrase we have to study more. We will take your views under consideration, but if your definition of "patient" means that you are a "patient" from the time you enter a hospital and you remain a "patient" because you might be subject to coming back to the hospital, that is too broad. I don't know that we can accept that definition. I doubt that AHA is recommending that specifically.

Reverend McGOWAN. We don't understand the term. It doesn't exist in medical terms.

Chairman PICKLE. It sure sounds like you opposed it.

Reverend McGOWAN. I take it the Congressman's question is about the hospitals moving off of health care. I think we are reminded there is a wide variety of practitioners, and all kinds of health care services, and the hospital is only one segment of that health care market.

Chairman PICKLE. I trust that if you have in a hospital a laundry service that is serving the public as a whole, that would—or if you have a pharmacy selling pills, medicine, to the public as a whole, no problem there?

Reverend McGOWAN. No; we are not in the computer business either.

Chairman PICKLE. The cafeteria, which is wide open to everybody. We are in general agreement on that. Now we ought to apply that rule appropriately in that field, and it is a reasonable matter, and I think that is what we try to drive at. When does the hospital become liable? I don't know that we know that exactly. We are not trying to win an argument here at all. We just are discussing it and listening to your arguments.

Dr. HEYSSEL. Traditionally, many hospitals have run outpatient departments primarily aimed at people in the surrounding community who come there. That is a pretty pure culture where the hospital has a hospital number on the patient and the patient returns for their outpatient care.

Second, there have always been in hospitals, patients who are patients of private physicians practicing in the community elsewhere, and we now report as unrelated business income tests done on that group of patients when it is referred to us, because basically, we run a reference laboratory, not a full service laboratory. That is straightforward.

It seems to me that we have got a problem with the changing organization of medical care. Under the health system and under many not for profit, and for profit hospitals, there is sitting out there a PPO or HMO or something, and people are enrolled, and in fact they are that organization's groups of patients through an insurance mechanism. They may not be, or they may be, directly related to the hospitals, depending on the organizational arrangements.

I think that is where our problem is. Inpatient, outpatient, we did 300 inpatient surgeries a year in 1984. We do now over 5,000, and none of the cataract patients aren't inpatients any longer. This has changed enough that the definitions are a little fuzzy.

Chairman PICKLE. We thank you, and we thank this panel. We are not trying to make some kind of argument here per se, because we are trying to find something that we can be certain is workable, and is fair to you and to private industry, and continues to serve the purpose. I agree that any change comes at a difficult time. I have never known that to be different.

I thank the panelists very much.

The next panel will be Mr. William Salisbury and Mr. Louis Marines, American Institute of Architects, and then Mr. Jack Bono. Each of you gentlemen may have someone accompanying you. If you will come up and take a place at the witness table.

William Salisbury, general counsel of the Copley Real Estate Advisors. Then we have Mr. Louis Marine.

Mr. MARINES. Marines, Congressman.

Chairman PICKLE. Just like the Marines. You have Mr. Deluca with you.

Mr. Salisbury.

STATEMENT OF WILLIAM J. SALISBURY, MANAGING DIRECTOR, COPLEY REAL ESTATE ADVISORS, INC.

Mr. SALISBURY. I am William Salisbury, a managing director of Copley Real Estate Advisors of Boston, MA. I want to thank you and the committee for providing me the opportunity to testify today about a somewhat technical issue, which we, who deal with it daily have really found hard over the past several years. We are responsible for more than $11 billion of our clients' real estate investments.

Copley and our colleagues in the pension real estate advisory business are fundamentally financial intermediaries. We have a number of clients who are major corporate and public pension funds and foundations and endowments, whose primary goal is to enhance their sources of income to pay retirement benefits, to meet the rising costs of education, and to support charitable causes.

We seek out real estate investment opportunities, structure transactions, and match such real estate investments with our investor clients.

We also assist investor clients in managing their real estate investments over their holding period of typically 10 to 15 years.

High quality commercial real estate has become an important source of such investments, providing stability and diversity for the typical investment portfolio of stocks and bonds. In many cases, investment pools are created to enhance diversity for nontax considerations. In some instances several of our clients get together and invest together in a project.

Pension plans and foundations are by their nature investors, and not active property managers or developers. Their investment in real estate, frequently takes the form of joint ventures, with real estate firms experienced in the development and management of real estate, but may also include other passive investors, too. Our clients rely on these firms to develop and manage the properties for them.

The issue I would like to discuss with you today is a tax exempt entity's ability to obtain mortgage loans from third parties as part of its investment in joint ventures in order to increase investment yields. Section 514(c)(9) of the code, which addresses this issue, has been amended every year since 1984. It is unworkable in its current form, which was enacted last December.

This is a fact the full committee acknowledged in the recent technical corrections bill, which would amend it again to correct acknowledged flaws in the 1987 statute. The cure proposed in the technical corrections bill is inadequate in our view. If I may, I will make several brief points and invite you to review our complete statement, which appears at page 33 in the discussions options booklet.

First, real estate investments are almost always leveraged. The appropriate amount of indebtedness depends on a number of nontax considerations. Over-leveraging—that is loading the real estate with too much indebtedness—is subject to control through a variety of Federal and State rules governing fiduciaries as well as through natural market forces.

Lenders will not provide loans unless they are convinced the debt can be serviced, which implies there is adequate equity in the property.

Second, tax exempt investment should be allowed to utilize mortgage indebtedness to enhance their returns to the same extent as on the investors. Not infrequently our tax exempt clients are investing side by side in the same transactions and on the same terms as taxable investors.

Unlike some other business activities under examination here today, no one has indicated that tax exempt entities are trading on their tax exemptions to outbid taxable persons for real estate investment opportunities, whether or not they are debt financed. Instead, the tax exempt investors are now at a severe disadvantage in competing, particularly with foreign investors, for quality real estate investments due to the burdens placed on them by the complicated, confusing and ever changing provisions of section 514(c)(9).

To the best of my knowledge, Congress has not questioned and is not now questioning, whether pension funds or college endowments should be able to make investments without incurring unrelated business income taxation. The law permitting such investments has been repeatedly changed in conflicting ways over the last 5 years. These constant changes, and in particular, the changes made last December, have made it more difficult, if not impossible for tax exempt investors to compete for these investments that are vital to the retirement security, education, and welfare of millions of Americans.

Before you propose new changes to this law, we urge you to amend the current law to permit nonabusive transactions. Moreover, with the reforms in the real estate and partnership areas of the law undertaken in 1986, there is no longer any meaningful potential for tax exempt investors to sell or trade unusable tax deductions to taxable entities. These tax losses to the extent they continue to exist at all, are not usable by taxable entities.

The complex rules in section 514(c)(9) enacted in 1987 will not catch anyone. They will not raise more revenue. They simply make it impossible for tax exempt clients to compete for prudent leveraged real estate investments even though congressional policy has favored such investments since 1980.

Finally, I turn the discussion to option 6, which seems to us to be a solution in search of a problem. We believe the 20 percent equity test is theoretically unsound and unworkable. Market forces and dictates of prudence ought to be the standards against which appropriate levels of indebtedness ought to be measured. The complexity of such a provision would be mind-boggling.

For example, I do not know whether the 20 percent test will be applied at the outset of an investment, throughout its life, whether it applies to the purchase price or fair market value, whether it permits refinancing, or how it affects long term phased multibuilding developments.

It is more difficult to offer useful comments on the past through entity proposal.

There seems to be confusion among staffs and members of the administration as to exactly what the substance and intent of this proposal is. However, taken literally, it would throw, we believe, the finely tuned rules governing passthrough entities into the same state of confusion, plaguing our tax exempt clients.

We urge you to recommend a simple amendment to 514(c)(9) that will allow tax exempt investors to utilize the mortgage indebtedness and joint ventures in the same manner as all other investors.

Our firm and others in the real estate advisory community would be happy to work with our staff to produce clearer, more concise language implementing this policy.

Thank you.

Chairman PICKLE. Thank you, sir.

[The statement of Mr. Salisbury follows:]

STATEMENT OF WILLIAM J. SALISBURY, MANAGING DIRECTOR, COPLEY REAL ESTATE ADVISORS

I am William J. Salisbury, a Managing Director of Copley Real Estate Advisors of Boston, Massachusetts. I want to thank Chairman Pickle and the Committee for providing me with the opportunity to testify today about a somewhat technical issue which we, who deal with it daily, have found most nettlesome over the past several years. This issue is section 514(c)(9) of the Internal Revenue Code of 1986, as amended (the "Code") -- the real property exception to the debt-financed income rules of the unrelated business income tax ("UBIT").

Before providing our specific comments, an introduction is appropriate. Copley and our colleagues in the pension real estate advisory business are fundamentally financial intermediaries. We have a number of clients who are major corporate and public pension funds, endowments and public foundations who seek to enhance and diversify their investment portfolios through the acquisition of interests in high quality commercial (and, sometimes, residential) real estate. We seek out such investment opportunities, structure transactions and match such real estate investments with our investor clients. Since real estate investments require much more intensive management than some other types of investment, we typically assist and advise our clients in the management of the investment during the entire time they hold the investment. In many cases, investment pools are created to enhance diversity and in some instances, several of our clients invest together in a project.

Our clients are long-term investors who view real estate as an integral part of a prudently diversified investment portfolio. The pension funds, for example, represent the largest single source of long-term equity capital for the real estate industry. Real estate historically has provided them with stable current returns and opportunities for appreciation in value. We and our colleagues have been responsible for acquiring, directly and indirectly, several billion dollars in office buildings, retail and industrial projects, and multi-family residential properties, on behalf of our clients as portfolio investments. Frequently, these investments in real property take the form of joint ventures involving both tax-exempt partners and taxable partners (who are typically developers or property management firms). Joint ventures offer pension fund and other tax-exempt investors the opportunity to gain from the expertise of professional real estate firms, who typically will make investment opportunities available only if they are able to participate in the transaction. Additionally, many of these investments are partially financed with third party debt, thereby increasing the potential investment return for the owners of the property. Some of the projects are developmental or rehabilitation projects, while most are acquisitions of existing property.

1. Development of The Discussion Options

Last summer, the Subcommittee held hearings on the administration of the UBIT provisions of the Code. The hearings focused on the issue of whether tax-exempt organizations are competing unfairly against small taxable businesses. The record of the hearings is virtually devoid of any discussion of investment in real estate by tax-exempt entities, largely because tax-exempt entities do not, as a practical matter, have any competitive advantage as investors in commercial real estate. Nevertheless, the discussion options set forth in Paragraph VI of the Subcommittee's press release of March 31, 1988 contain two proposals that would constitute major changes in the UBIT treatment of real estate investments by tax-exempt entities. These proposals -- imposing a 20 percent equity requirement and a new pass-through entity rule -- would generally have the effect of reducing investment returns for tax-exempt investors and, therefore, would make it more difficult for domestic pension funds and other tax-exempts to compete for investment opportunities against other investors, particularly foreign investors. For several reasons, these proposals should not be adopted.

First, pension funds and other tax-exempt organizations that invest in real estate have not yet recovered from the stream of changes in section 514(c)(9) that have been enacted or proposed in every year since 1984, some of which have been given retroactive effect. Section 514(c)(9) initially was added to the Code in 1980. It was then amended in 1984, amended again in 1986, and then amended once again in 1987. Additional changes to the statute have already been proposed in the recently introduced Technical Corrections Bill of 1988 (H.R. 4333). Some of these amendments were intended to correct errors, or perceived errors, in previously enacted amendments. One result of this series of amendments is that little or no investment in joint ventures with leveraged real property by tax-exempt organizations has occurred since October 13, 1987, because it is virtually impossible in any actual transaction to satisfy either the qualified allocation or disproportionate allocation tests of the 1987 amendment to the statute. Further, many transactions that had been planned over a long period could not proceed to completion because of the 1987 amendment. Most importantly, it has been impossible to plan or negotiate new investment transactions because of fears about additional changes in the law. Thus, the cumulative effect of these changes has been a de facto, unintended repeal of the UBIT exception for debt-financed real estate by joint ventures, despite the fact that Congress continues to support the ability of pension funds and endowments to engage in such transactions without incurring UBIT.

The impact of these recent changes to section 514(c)(9) can be illustrated by the following typical transaction. A group of pension funds and college endowments invest as limited partners to develop, build, lease and hold an office building with a taxable developer. The tax-exempt organizations contribute most or all of the capital while the developer may make a small capital contribution and will manage the construction and operation of the property. A nonrecourse loan is obtained for the balance of the acquisition price, although during construction the developer might be required to guarantee the loan. The tax-exempt partners are entitled to priority distributions of a fixed rate of their invested capital (or, perhaps, of their excess capital), and 80 percent of the remaining profits; the remaining 20 percent of the profits flow to the developer. After the investor partners have recouped their capital, the developer is entitled to one-half of the profits. In a perfect world, the tax allocations would follow the cash distributions -- with cumulative income allocated to the tax-exempt entities to the extent of their cumulative preferred distributions and thereafter in accordance with their share of the excess distributions of profits. Losses would be allocated in accordance with the partners' share of profits (in excess of priority distributions), subject to the restrictions on losses contained in the section 704(b) substantial economic effect regulations.

This transaction would not have caused the pension fund to have unrelated business income ("UBI") between the enactment of the 1980 legislation and October 13, 1987, although this result would not have been evident between the effective date of the 1984 legislation and the enactment of the 1986 legislation (because the technical correction was retroactive). The endowment would not have been able to invest in such a transaction with no expectation of deriving UBI except during the period between the enactment of the 1986 legislation and October 13, 1987. However, despite the fact that this transaction is not tax motivated, it does not satisfy either the qualified allocation test or the new disproportionate allocation test of section 514(c)(9)(E). In fact, even if the profit sharing ratio was 50-50 at all times, the tests could not be satisfied. As evidence that these transactions are not tax motivated, you should note that the same investment structure is used when all or some of the partners contributing the capital are taxable.

Second, based on the absence of any discussion of real estate investments during the 1987 hearings, there is no basis for raising these issues at this time. In this regard, the 1987 hearings focused on the competition issues -- in particular, the disadvantages that businesses face in trying to compete with tax-exempt colleges and foundations. Ironically, the competition issue also affects real estate investments, but in exactly the opposite way. Because of the tax law changes referred to above, pension funds, endowments and other tax-exempt investors are now at a severe disadvantage in competing with foreign investors for quality real estate investments.

Third, the discussion options are too vague to be understood and have no apparent underlying policy except to undercut the ability of pension funds, endowments, foundations and charities to invest in real estate.

2. The Discussion Options Conflict With Other Policies

These obstacles blocking tax-exempt investment in real estate will have a significant adverse economic impact on tax-exempt organizations and should, therefore, be important to the Subcommittee. Over the last several years, too much effort has been concentrated on narrow, highly theoretical and often specified tax abuse concerns, while broader national economic policy concerns have been ignored. For example, real estate provides an optimal long-term, income-producing investment for pension funds, which, in turn, are essential vehicles for the retirement income security of millions of Americans. Congress is continually faced with concerns with respect to whether today's workers will be able to retire with a secure source of adequate retirement income. In one respect, Congress dealt with this issue in a comprehensive manner in 1974 with the enactment of ERISA provisions compelling pension fund asset managers to make prudent investments to meet the retirement needs of beneficiaries and to diversify pension fund portfolios. Yet, recent amendments to UBIT provisions such as section 514(c)(9) severely undermine this policy objective by reducing the availability of attractive, secure, income-producing investments.

Similarly, education has become a great national concern. The cost of a college education has escalated beyond the means of most Americans, while federally funded subsidies and guaranteed loans for higher education have been slashed. In order to educate our next generation of teachers, scientists, leaders and scholars, the cost of education must be met by means other than tuition and subsidies. Yet, by unduly restricting the ability of college endowments to invest in attractive, income-producing real estate opportunities, their ability to find alternative means to help defray the costs of education are reduced. The same problem exists for foundations and public charities seeking to pick up the slack as the federal government has reduced social welfare programs over the past decade. By denying these organizations the opportunity to compete with foreign investors who own real estate in the United States, their ability to obtain the returns necessary to meet society's social welfare obligations is hampered.

Accordingly, we urge the Subcommittee or full Committee to keep in mind the desired policy underlying the debt-financed real property UBIT exception contained in section 514(c)(9) and determine (i) whether the current statute advances that policy, and (ii) whether the proposed options (as well as the proposed technical corrections to section 501(c)(25), and possible technical corrections to last year's amendments to section 514(c)(9)) will serve or interfere with that policy.

HISTORY OF THE DEBT-FINANCED INCOME RULES AND THE REAL PROPERTY EXCEPTION

1. 1950 Act

We turn now to the policy underlying both the UBIT and debt-financed property statutes in general, and the real property exception in particular. The best place to start is with the enactment of the original UBIT statute in 1950. Like the current study by the Oversight Subcommittee, the original UBIT statute was triggered by and directed primarily at the problem of unfair competition to for-profit corporations and the resulting revenue loss to Treasury. H. Rep. No. 2319, 81st Cong., 2d Sess 27 (1950). Congress wanted the business of charity to be charity, supplemented by passive earnings on its capital funds. The original UBIT statute was in response to the extension of the "destination of the income" test by the courts. E.g., Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938). As originally enacted, the UBIT provisions applied only to certain exempt organizations. State colleges and universities were subjected to UBIT in 1951, qualified plans in 1954, and most other exempt entities in 1969.

Excluded from the definition of UBI in the 1950 statute and at all times thereafter were the traditional forms of passive investment income earned by exempt organizations, such as dividends, interest, royalties, gains and losses from the sale of property (except stock in trade, property held for sale to customers or timber cut by the organization), and rents. Not all rents, however, were excluded from the definition of UBI in 1950. Due to concerns relating to the unfair competitive advantage that tax-exempt purchaser-lessors might have in sale-leaseback transactions, Congress characterized as UBI net income from debt-financed property leased for more than 5 years. While the impetus for the statute was sale-leaseback transactions, it applied regardless of whether the seller and lessee were related. The 1950 statute was designed to tax only the income derived from and allocable to the debt-financing. Income allocable to the capital invested by the exempt organization was not considered UBI. Accordingly, the amount of net income constituting UBI was limited to the ratio of the debt-financing to adjusted basis. Minor changes were made to this provision in 1954.

2. Tax Reform Act of 1969

In response to Commissioner v. Clay B. Brown, 380 U.S. 563 (1965), and similar abusive transactions, the UBIT provisions were amended after careful study in 1969. Some of the amendments expanded the scope of section 514 by extending the debt-financed property rules to unrelated income from all debt-financed property, and not merely to rental income from real property. Other changes made in 1969 involved the use of average basis and acquisition debt figures for computing the ratio of income from debt-financed property that would be characterized as UBI, limiting depreciation to straight line, and other changes limiting expenses that could reduce UBI.

3. 1980 Act

By 1980, Congress recognized that the 1969 amendments to section 514 represented overkill in certain circumstances. In particular, the restrictions on debt-financed income were inappropriate when applied to prudent, debt-financed real estate investments by qualified retirement trusts. Unlike other exempt organizations, the purpose of the exemption for the investment income of such trusts was to enable them to accumulate funds, which eventually would be used to pay employee benefits, taxable to the recipients at ordinary rates. Real estate investment enabled the trustees to diversify their investment portfolios and historically provided a hedge against inflation.

In light of these considerations, as well as the fact that real estate acquisitions were commonly debt-financed, Congress enacted, as section 514(c)(9) of the 1954 Code, a narrow real property exception from the definition of "acquisition indebtedness." This exception generally excluded debt incurred by a qualified trust as a result of the acquisition or improvement of real property. Pub. L. 96-605, § 110(a), 94 Stat. 3525. As originally enacted, this section specified five situations when the real property exception would not apply. These situations encompassed areas in which Congress had concerns regarding abuses under pre-1950 and pre-1969 law that had caused it to previously tax all debt-financed income.

4. 1984 Act

In the Deficit Reduction Act of 1984, Congress reexamined the 1980 exception for certain debt-financed real property by extending the qualified plan exception of section 514(c)(9) to real property held by certain educational institutions (as defined in section 170(b)(1)(A)(ii)) and certain affiliated support groups. Pub. L. 98-369, § 1034(a), 98 Stat. 1039. The price for expanding the class of tax-exempt entities qualifying for the debt-financed property exception was to impose new restrictions applicable to partnerships including exempt and taxable organizations (including organizations with UBIT). Section 514(c)(9)(B)(vi). At that time, Congress indicated that it was concerned with the potential ability of pension trusts (and other exempt entities) to shift tax benefits, such as unused ACRS deductions on debt-financed property, to taxable entities. Under the 1984 amendment, an organization that was a partner in a partnership holding real property could qualify for the section 514(c)(9) exception to the debt-financed property rules only if either (1) all of the partners were organizations qualifying for the exception, or (2) each allocation to a qualified organization was a qualified allocation. For purposes of these rules, if the pension trust or educational organization had any other UBI, it would not be treated as an organization qualifying for the section 514(c)(9) exception unless the partnership had qualified allocations.

An allocation constituted a qualified allocation under these rules if it met the partnership allocation rules under the tax-exempt entity leasing provisions of section 168(j)(9). These allocation rules required (1) that the qualified organization be allocated the same percentage share of each item of partnership income, gain, loss, deduction, credit and basis (excluding allocations attributable to contributed property), (2) this share remain the same during the entire term of the partnership, and (3) that the allocation have substantial economic effect under the section 704(b) partnership regulations. Similar rules applied in the case of any pass-through entity other than a partnership and in the case of tiered partnerships. Treasury was granted broad authority to promulgate regulations necessary or appropriate to carry out the purpose of these provisions.

While at first glance the 1984 Act was thought to broaden the real property exception, its practical effect was devastating to many common, non-abusive debt-financed transactions. A substantial portion of such investments involve joint ventures because the taxable partners are in the business of real estate develolpment and management, whereas pension funds and endowments are passive investors, and not active developers or managers of real estate. Most pension funds do not have the personnel or expertise to engage in such activities. In addition, joint ventures assist the tax-exempt investor in prudently diversifying its portfolio. Thus, joint ventures arrangements are an essential part of real property investment by tax-exempt organizations.

The qualified allocation test presented (and still presents) a number of obstacles. First, it does not permit preferred returns to the tax-exempt investor, who typically contributes most of the capital to the transaction, and even the level of permitted guaranteed payments to a tax-exempt investor is unclear. Second, it does not permit a tax-exempt investor to have limited liability without incurring or the risk of incurring UBIT. Third, it does not take into account differing capital contributions by the partners without imposing deficit restoration obligations on those partners with disproportionately small contributions. In the rare situation that a developer (which normally has the small contribution) is willing and able to undertake a deficit restoration, the impact is to accelerate deductions to the taxable partner from the tax-exempt entity; this result is hardly to the benefit of the Treasury. Fourth, qualified allocations do not clearly permit incentives to a managing general partner because such incentives may constitute a shift in the allocations. As a result of these problems, leveraged investment in most real property by most qualified organizations largely came to a halt.

5. 1986 Act

Scarcely had the ink dried on the 1984 amendments to section 514(c)(9) before Congress amended it again. In 1986, section 514(c)(9)(B)(vi) was changed again in two subtle but important ways. First, the requirement that allocations be qualified allocations was liberalized to a "principal purpose of tax avoidance" test. The test was changed because transactions involving qualified organizations (qualified plans and educational endowments) and other persons or entities could not be done under the 1984 qualified allocation standard. This noncontroversial change occurred in a technical amendment. Had the conference report described the scope of this provision and set forth situations in which a tax avoidance motive would be presumed, no further amendments of the statute would have been necessary.

The second 1986 change involved the addition of section 501(c)(25) collective investment entities to the Code and their inclusion as qualified organizations eligible for the real property exceptions of section 514(c)(9). By investing through a section 501(c)(25) entity, a foundation or charity could receive the benefits of the real property exception it could not enjoy had it invested directly in the property. (Section 116 of H.R. 4333, the Technical Corrections Bill of 1988, would eliminate this benefit retroactively). Similarly, the status of a public pension fund or state or local governmental unit investing through a section 501(c)(25) entity was clarified.

An equally significant change made by the 1986 Act has been totally ignored in discussions of section 514(c)(9) since 1986, to wit, the radical reduction in the value of tax benefits pursuant to that legislation. The institution of the passive loss rules, the extension of the at-risk rules to real estate, the requirement of capitalization of construction period interest, and the reduction in rates, combined with the fact that in most cases the property will have to be depreciated over a 40-year useful life, makes the tax benefits available in these cases of relatively small value. Moreover, because of the passive loss rules, these benefits are only of use to certain corporations and those developers who happen to have substantial cash flow from other investments.

6. 1987 Act

Early in 1987, however, some tax writers became concerned that the 1986 amendment to section 514(c)(9) went too far. No abusive transactions otherwise permitted under prior law were presented to justify this belief. In fact, the purported abusive examples that were mentioned could not have passed muster under section 704(b)(2) and the 1986 version of section 514(c)(9)(B)(vi). Nevertheless, the restoration of the qualified allocation standard was included on the 1987 list of revenue options considered by the Ways and Means Committee. Interestingly, such a provision was initially projected to raise $400 million over a 3-year period, while the prior year's technical amendment (that it reversed) lost no revenue. H.R. 3545, as passed by the House, would have restored the qualified allocation standard. Although the Senate bill contained no similar provision, the conference agreement reinstated the qualified allocation standard and added the alternative disproportionate allocation test of section 514(c)(9)(E). Unfortunately, this hastily drafted conference agreement is internally inconsistent and effectively constitutes the de facto repeal of section 514(c)(9) for debt-financed joint ventures. The Treasury Department, taxpayers and tax-exempt investors are all dissatisfied with the current statute.

7. Technical Corrections Act of 1988

Section 204(g) of the H.R. 4333, which would amend section 514(c)(9)(E) to give Treasury additional regulatory authority to resolve conflicts between the statutory tests, is insufficient to make the statute workable. For example, section 514(c)(9), in its current form, causes qualified organizations that are limited partners to have UBI unless they agree to unlimited liability. Yet, pension funds prefer to invest as limited partners precisely to limit their exposure to such risks. In fact, some trustees may interpret their fiduciary obligations as prohibiting them from undertaking such risks. Thus, prudent, passive investing designed to protect a pension fund's corpus would be subject to UBIT whereas a fund that placed all of its funds at risk would not. No sound tax policy can justify such a result.

Even with the proposed 1988 technical amendment and assuming prompt issuance of regulations, many perfectly straightforward transactions will still not qualify for section 514(c)(9) treatment. For example, if a taxable investor and a tax-exempt investor each provide $500 of capital for a partnership in which a managing general partner is allocated 20% of the profits until a specific event occurs and 40% of the profits thereafter, the tax-exempt partner will not be entitled to the benefits of section 514(c)(9). There seems no reason whatsoever why the tax-exempt investor should not be entitled to the benefits of section 514(c)(9) under these circumstances.

POLICY CONSIDERATIONS

1. Need for Certainty

In short, tax-exempt investors are frustrated by this constant changing of the statute. For sound domestic economic policy reasons, Congress has taken the position that pension funds and endowments may make leveraged investments in income producing real property without incurring UBIT; this decision should not be undermined by placing undue restrictions on such investments, particularly where those restrictions are based on vague and unsubstantiated reports of theoretically possible abuses. In addition, section 514(c)(9) must be restored to a workable format for debt-financed joint venture investments.

Pension trusts and other tax-exempt organizations are long term investors who expect certainty of tax structure in making their investments. Negotiations for these investments occur over many months and the actual investments at times are made over several years. Changes in the law can dramatically change the expected investment yield from an investment. Moreover, the theoretical opportunity for abuses cannot justify the additional time and expense needed to monitor and comply with these constant changes in the law.

2. The Hearings Do Not Justify These Discussion Options

Given these concerns over an already constantly changing statute, the Subcommittee's discussion options for unrelated debt-financed income are puzzling. Virtually all of the other discussion options are based on issues and concerns raised during the hearings last summer. The real property exception to unrelated debt-financed income, however, was not substantively discussed at the hearings. Moreover, the policy underlying the real property exception, to the best of our knowledge, has not been called into question. Unlike a number of other business activities, no one has complained that qualified organizations are somehow trading on their exemption to outbid taxable persons for real property and/or tenants. If anything, the market for real property has been skewed by foreigners investing in the United States and accepting lower rates of return than domestic investors. Tax-exempt investors are at a disadvantage in competing for quality real estate investments due to the shackles placed on them by the tax code; taxable developers and managers may become reluctant to negotiate with pension funds or endowments due to the fear that they will need to restructure an agreement to meet annual changes in the tax law.

No arguments have appeared on the public record indicating why the discussion options constitute sounder tax policy than current law. Tax-exempt organizations are not trading on their tax-exemptions. Leveraged investment in real property continues to be part of a sound national economic policy for pension funds and endowments. If anything, these proposals undercut the broad Congressional policy regarding retirement income security, the affordability of higher education, and the social welfare of the less fortunate in our society.

3. The 20 Percent Equity Test Makes No Sense

No policy rationale has been articulated for this 20 percent equity test. The 20 percent test seems to be imported from residential real estate, whereas lenders for commercial property use debt service coverage ratios. In short, we believe that this proposed restriction is unnecessary. It is not a problem in the market; lenders will not provide funds if the security is insufficient and developers and other investors do not give tax-exempt organizations "free rides" in their properties. The 20 percent rule reinstates the general debt-financed income ratio test, with an arbitrary additional requirement that a ratio above 80 percent debt-financed income causes all of the income to be UBI. Congress has rejected the regular "ratio test" in the context of qualified organizations investing in real property. It is logically inconsistent to impose a stricter test in its place while maintaining that the policy for the original exception remains unchanged.

The 20 percent test will not impact the vast majority of investments by qualified organizations. However, the problem with injecting the 20 percent equity standard into the Code is that every investment must then be policed to avoid the loss of section 514(c)(9)'s benefits. Policing this additional standard would reduce yields and burden society with additional non-productive costs.

Moreover, the proposed 20 percent threshold equity test is incomprehensible in its present form. For example, what is the base on which the required investment is calculated and what will constitute an investment for this purpose? Must the tax-exempt organization invest cash or is a partially or fully recourse obligation sufficient? Does the 20 percent relate to initial purchase price or fair market value? How do improvements to the property affect the base against which the 20 percent is measured? Do cash flow distributions and depreciation reduce the investment in the property so that the tax-exempt investor will eventually become taxable? If a loan is refinanced, does the 20 percent test continue to apply and, if so, 20 percent of what? Our inquiries indicate that these issues have not been considered by the Subcommittee. Leaving these issues to be resolved by regulations is of no value to taxpayers until regulations are issued, a process that can take years.

4. The Pass-Through Provision is Unneeded

Paragraph VI of the discussion options also states that the character of debt-financed income received from all pass-through entities by a pension fund or endowment should be retained. This provision is totally unnecessary and undesirable.

On its face, this provision is unclear. Among other suggestions, we have been informed that this new proposal to retain the character of debt-financed income received from all pass-through entities may be intended to apply primarily to income from REITs, RICs, and REMICs. This proposal should be eliminated because it would reclassify these entities from carefully regulated partial conduits into pure conduits without taking into account the entire system that has been developed for taxing distributions from these entities.

For example, in determining the character of distributions from a REIT, Congress decided not to look through the REIT to see how it earned its income. Congress has already established an elaborate set of rules to govern how a REIT may earn its income, including the kind of investments it can make. Once these tests are satisfied, however, the income and distributions are all taxed in the same manner. Thus, dividends from a REIT are uniformly treated as portfolio income for purposes of the passive loss rules. If a pass-through approach were to be used, most of the income would be passive under section 469 and could be used to offset losses from any tax shelters. Distributions from a REIT are currently excluded from UBIT because an investment in a REIT does not differ in any material way from investments in shares of stock in a corporation. Similarly, an investment in a REIT by a RIC is treated as stock or securities for purposes of the kinds of income a RIC may receive. It is the same type of passive-type income generally excluded from UBI under Section 512.

If you look through a REIT for purposes of examining whether it has debt-financed income, you are really treating the REIT like a partnership for some purposes but not others. The character of a REIT should not be trifurcated for purposes of the treatments of losses, passive versus portfolio income, and taxable versus tax-exempt partners.

In short, this radical change would produce myriad technical problems which neither we, our advisors, nor the authors of this proposal have begun to consider. It should not, therefore, be put forward until its consequences can be reasonably understood.

For example, assume that a pension trust invests in two REIT's, one of which produces taxable income and the other of which produces losses. Will the pension trust be able to offset the losses in one REIT against the profits in another? How can it be sure that it will be able to obtain the information it will need to comply with the Code if the REIT's management takes the perfectly reasonable position that it is unwilling to burden its other investors with the costs of supplying this information?

5. The Rent Based Upon Net Income Test

We agree with the substance of the proposal that would exempt from UBI contingent rental income received from a prime tenant attributable to fixed rents paid by a subtenant. In general, rents that could have been received tax-free from a lessee should not become taxable when received indirectly from sublessees through a lessee. Obviously, this exception should apply to rents received from a prime tenant attributable to rents received from a subtenant whose rent is based upon a percentage of gross receipts or sales. Since the exempt organization itself could receive rents of the types being paid by such subtenants and itself pay the expenses of operating the property, there would seem to be little reason to prevent an exempt organization from indirectly receiving a portion of the same net income from the operation of the property.

We would make one further recommendation. There seems to be no reason why the statute applicable to exempt organizations should not contain a provision paralleling section 856(d)(4) which would subject exempt organizations to UBIT only on that portion of any contingent rent received from a tenant attributable to rents paid by a subtenant dependent upon its net earnings. The principal purpose of such a provision would be to avoid accidental disqualification of the entire rent from a property where a tenant mistakenly enters into a sublease which calls for contingent rent paid on net income. At the same time, this protects Treasury by subjecting the portion attributable to such payments to UBIT.

6. Commitment Fees

We also agree with the proposal that exempts from UBIT investment income earned from non-refundable loan commitment fees. This is a good rule that complies with the statutory policy because commitment fees are a normal component of lending money and are consistent with fees charged by a passive lender. The lender is simply being compensated for evaluating the loan and for committing funds that could otherwise be invested elsewhere.

7. Public Pension Funds

While you are examining this area, you should clarify an unnecessarily clouded issue in the law. Public pension funds do not need to obtain determinations that they are exempt under section 401(a) of the Code. Accordingly, some have questioned, at least in theory, whether they are qualified organizations for purposes of section 514(c)(9), or are otherwise exempt from tax under section 115 or on constitutional grounds. We believe that this issue should be clarified by explicitly including governmental plans and entities (as defined in section 501(c)(25)(C)(ii) and (iii)) in the list of qualified organizations under section 514(c)(9)(C).

CONCLUSION

We commend the Subcommittee for engaging in its study of the UBIT. It makes sense every 15-20 years for Congress to step back and take a fresh look at how well an area of the Internal Revenue Code is working and whether its underlying policy is still sound and is being implemented. Unfortunately, over the past four years, Congress has amended section 514(c)(9) many times without this careful reflection. This has wreaked havoc with the tax-exempt entities qualified to use the section, as well as their potential partners. We would certainly support the Subcommittee in a serious and thoughtful study of the tax on unrelated business taxable income as it applies to real estate investments. However, the proposals made in the March 31 press release seem to us the result of mere tinkering rather than of any comprehensive review of the subject matter.

No evidence has been developed that the types of purported abuses at which the 1984 and 1987 amendments and the current proposals are aimed are widespread or even significant, when compared with the total amount of real estate investments made by tax-exempt organizations. We therefore urge the Subcommittee not to pursue any of the proposals in the press release (other than those ameliorative proposals described under the heading "Miscellaneous") and defer legislation on this subject until a thoughtful and thorough study of the problems in this area and the manner in which funds are being invested in real estate by tax-exempt organizations can be carried out. In the interim, what is needed is a correction of section 514(c)(9) in its current form so that it fulfills the Congressional purposes of permitting pension funds, endowments, and collective investment entities to make leveraged real property investments, while preventing the improper shifting of losses or income between the taxable and tax-exempt sectors.

Chairman PICKLE. Now, Mr. Marines.

STATEMENT OF LOUIS L. MARINES, EXECUTIVE VICE PRESIDENT, AMERICAN INSTITUTE OF ARCHITECTS, ACCOMPANIED BY FRED DELUCA, CHIEF FINANCIAL OFFICER

Mr. MARINES. My name is Louis Marines and I am executive vice president of the American Institute of Architects, the professional association representing this Nation's architects. I am substituting for the scheduled witness, Don Hackl, who was not able to be here. I am accompanied by Fred DeLuca, our chief financial officer.

AIA has chapters in each State and in many localities that promote AIA issues on a local basis. The national AIA is a 501(c)(6) organization and pays taxes in accordance with the 990-T regulations. My views today also reflect those of the Printing Industries of America and Associated Builders and Contractors.

Mr. Chairman, the AIA commends this committee and applauds your efforts to seek information on unrelated business income tax reforms from the broad range of trade and professional associations who would be affected by decisions you may reach on this issue. We support congressional examination of the UBIT area of the Tax Code to find improved ways to curb abuse through stepped up enforcement and tighter reporting needs.

At the same time, we strongly urge that any legislation carefully distinguish between necessary reforms and those which may undermine the activities of professional associations which a tax-exempt status was meant to foster.

We support targeted reforms and oppose broad-brush solutions. Options do not include the UBIT on net investment income. We strongly support this omission.

We oppose efforts to couple proposals to apply UBIT to net investment income with any other unrelated legislation. AIA pays substantial taxes on those activities deemed unrelated to the tax exempt purposes of our organization. For example, we pay taxes on advertising income. We pay taxes on the rent we receive from tenants and on income from the sale of lists.

The income we receive is used for many activities that benefit the profession and the public at large. These include public TV programming, research on life safety aspects of building design, scholarships for students, public outreach programs to relieve the plight of the homeless, disaster relief teams, teams of volunteering architects who work with urban communities to develop comprehensive plans for historic areas and other designated places, and programs for improving practices in our profession.

With this in mind, I would like to focus on a few options that would affect us in particular. One option would apparently subject most off-premises sales to taxation simply based on the offsight nature of the sales. AIA items sold offsite, the same as those sold onsite, are clearly related to the purposes of our organization and therefore, should not be subject to taxes.

Typical of our related educational publications are the AIA contracts and forms, and "Handbook of Professional Practices." Our contracts and forms are the standards documents in the construction industry. They establish clear lines of responsibility and accountability between architects and contractors. No other organization competes with AIA in the production of these documents. The building industry recognizes them as fair and complete.

Our "Handbook of Professional Practice" is sold to architectural schools for use in their curricula. As with the AIA contracts and forms, there is no private competitor. National AIA sells most of our contracts and forms and the handbook to AIA State and local societies, which in turn, sell them to AIA members and contractors. Whether these publications are sold onsite or offsite has no bearing on their educational or public safety purpose. The income should not be subject to UBIT.

We oppose the application of UBIT to another income source—royalties for which the related organization performed substantial services or incurred substantial costs. A good example is our "Architectural Graphic Standards." This book is produced in cooperation with a commercial publisher and over 200 members contribute to the content, placing thousands of hours without compensation. This book is recognized by the profession as the "bible" of our industry.

Since the copyright was deeded to AIA and a commercial publisher in the early 1900's, AIA has received royalties on the sale of this book. The entire purpose of our involvement is educational. Under the discussion options, all royalties would be subject to taxation due to our substantial investment in editing and graphics and our involvement in the development of other aspects of this publication.

While the basis of this action appears to be an assumption that much involvement and cost constitute a commercial interest there is no commercial connection. Such a basis has no relevance to our particular situation, since the undertaking is educational, not commercial, or competitive.

The most drastic proposed measure has to do with allocation rules. Our major concern involves the nondeductability of overhead. We feel once an item is deemed to be taxable, normal rules should apply. Revenue minus direct expenses, minus indirect expenses, minus overhead, equals profit.

Mr. Chairman, we recognize there needs to be some tightening of the laws pertaining to the UBIT, and we are prepared to make the necessary adjustments. We ask that any new provisions be as clear as possible so abuses are reduced and worthwhile activities encouraged and protected. This testimony, we hope, will help lead to that goal.

Thank you.

[The statement of Mr. Hackl follows:]

STATEMENT OF DONALD J. HACKL, AMERICAN INSTITUTE OF ARCHITECTS

Mr. Chairman and members of the Subcommittee, I am Donald Hackl, FAIA, immediate Past President of The American Institute of Architects and a principal in the architectural firm of Loebl Schlossman & Hackl, in Chicago, Illinois. I am testifying on behalf of The American Institute of Architects, the nonprofit professional association representing the nation's architects. The AIA has chapters in each state and in many localities . Each of our entities are separate legal corporations, all paying their appropriate taxes individually. The national AIA is a 501(c)(6) organization and pays taxes in accordance with the 990-T regulations. My views today also reflect those of the Printing Industries of America and the Associated Builders and Contractors.

The AIA commends the Oversight Subcommittee for its deliberate approach to UBIT reforms and particularly applauds the subcommittee's efforts to seek information from the broad range of trade and professional associations that would be significantly affected by the decisions the Subcommittee may ultimately reach on this issue. We support Congressional examination of the UBIT area of the tax code to determine improved ways to reduce abuse of this section of the tax code. We endorse stepped-up enforcement of the UBIT and tighter reporting requirements by tax-exempt organizations. At the same time, we strongly urge that any legislation carefully distinguish between necessary reforms to curb abuse and provisions which may undermine the public purpose activities of professional associations that the tax-exempt status was meant to foster. We support targeted reforms and oppose broad brush solutions and believes that the public interest is best served by the deliberate review of this complex area of the tax code.

We note that the list of discussion options does not include the UBIT on net investment income. We strongly support the omission of this item from consideration. We also oppose any efforts that may arise to couple proposals applying UBIT to net investment income with other unrelated legislation. Such action would, of course, undermine the integrity of the review of the discussion options.

In responding to the discussion options for legislative change of the UBIT, it is important to recognize AIA's activities and practice under current law. We already pay substantial taxes on the income from those activities deemed unrelated to the tax-exempt purposes of the organization. For example, we pay taxes on advertising income. We also pay taxes on the rent we receive from tenants in our building. And we pay taxes on income from sale of lists.

At the same time, the income we receive from investments and royalties is used for many activities that benefit both the profession and the public at large. These activities include:

- public television programming to educate the public about the role of the architect in society;
- research on life-safety aspects of building design such as long spans;
- scholarships for students throughout the United States. The AIA spends over $300,000 a year on this purpose;
- public outreach programs to relieve the plight of the homeless. The AIA's Search for Shelter program, operating in more than 30 cities, brings together architects, community leaders, elected officials, homeless advocates, and others to find creative solutions to local homeless conditions;
- disaster relief teams dispatched at AIA expense to help stricken communities rebuild after hurricanes, earthquakes, floods, and other natural disasters;
- teams of volunteering architects who work with urban communities to develop long-range, comprehensive plans for historic areas and other specifically designated places; and
- our basic programs of improving practices in the profession and the building industry generally.

If the income that allows us to engage in these activities is reduced because of substantial additional taxation, we would have to cut back or eliminate them, to the detriment of the profession and the public. Because these are not activities performed by the private sector, it would be up to the government to fill the gap. The other alternative would be substantial and, frankly, unacceptable increases in dues to our members, the overwhelming number of whom are in small businesses. They belong precisely and ironically to the general class of people whose interest this whole exercise in UBIT review is designed to protect.

For the most part, the discussion options for subcommittee consideration do not apply to the AIA. There are others that could have substantial impact on our ability to generate the revenue to support our public purpose activities. A major problem generally with many of the options is that they inadequately or unclearly separate the abuser from the non-abuser and may have the effect of penalizing professional associations inappropriately.

We would like to focus on several of the options in particular.

1. Sales of Publications.

One option would subject certain bookstore sales to taxation apparently based on the off-site nature of the sales. The AIA operates a bookstore. A number of the items it sells may properly fall under the list of items that would be subject to tax. Other items sold on-site are clearly related to the purposes of the organization and therefore would not be subject to tax. We do not have a catalog sales program aimed at the general public. In addition, there are two major kinds of publications that the AIA produces and distributes on a national level to its members and the public through the bookstore and mostly through off-site transactions. These publications are essential to the architectural profession and the safety of the public. The first kind is the AIA contracts and forms which are actually sold separately and the second is the Handbook of Professional Practice.

The AIA contracts and forms are the standard documents in the construction industry that establish clear lines of responsibility and accountability between architects and contractors. These documents help ensure that the buildings we design are safe for the public. No other organization or corporation competes with AIA in the production of these documents, on which the AIA holds the copyright. The building industry recognizes them as fair and complete.

The Handbook of Professional Practice is a four volume series written by AIA members. They do not receive compensation for this work. Its purpose is to provide a comprehensive educational resource guide to the practice of architecture. The handbook is also sold to architectural schools for use in core curricula. As with AIA contracts and forms there is no private competitor.

The National AIA sells most of its contracts and forms to AIA state and local societies which in turn sell them to AIA members and contractors. The handbook is marketed in much the same fashion. Whether these publications are sold on-site or off-site has no bearing on their educational and/or public safety purpose. In our opinion, the UBIT should not be levied on the income received from sales of these publications.

2. Royalties.

The AIA is also concerned with the royalty issue. We are in support of the subcommittee's suggestions to apply UBIT to royalties measured by net or taxable income, but not with the additional language calling for the application of UBIT to royalties received from other purposes, specifically royalties for which the related organization performed substantial services or incurred substantial costs. A good example of this is our publication entitled Architectural Graphic Standards. This book is produced in cooperation with a commercial publisher and is largely the result of members' input. Over 200 AIA members contribute to the content of this publication. They receive no royalties or compensation for their work. The book is recognized by the profession as the "bible" of the industry. Since the copyright was deeded to both the AIA and the commercial publisher in the early 1900's, the AIA has received royalties on the sale of the book. The entire purpose of AIA's involvement is educational, yet under the discussion options, all royalties would be subject to taxation due to AIA's substantial cost and involvement in the development of the publication. The purpose again is educational, not commercial, but your option does not seem to differentiate.

3. Allocation Rules.

Probably the most drastic measure contained in the list of options has to do with allocation rules. The issue here is one of equity and fair taxation rules because this option would deny normal deductions. The major concern involves the non-deductability of overhead. The AIA feels that if an item is deemed to be taxable, normal taxation rules should apply, i.e., revenue minus direct expense minus indirect expense minus overhead equals profit. In today's association environment, the executive vice president, general counsel, and financial management staff spend a considerable amount of time on income-producing projects. Considering the possible tightening of the laws in the UBIT area, it will be even more important to have management oversight on these activities. To exclude deductions for general overhead properly allocable to activities subject to tax is inconsistent with the tax laws and is a real discrimination against organizations like ours. In the area of advertising, to allow only direct advertising expenses ignores the accounting theory of full cost absorption, which private enterprises may rely upon to reduce their tax burden. It also assumes illogically that people buy a magazine for the advertising not the content.

4. Information.

The AIA is generally in support of your initiative to obtain more information on the 990-T and would encourage you to obtain more factual data before you legislate these issues. Please be aware that associations are different from private enterprises in their purpose and much needs to be understood before fair taxation can be accomplished.

We recognize that there ought to be some tightening of the laws that pertain to the UBIT and we are prepared to make our necessary adjustments. We do, however, ask that any new provisions be as clear as possible and as targeted as possible, so that abuses are reduced and worthwhile activities encouraged and protected. This statement, we hope, will promote that goal.

Chairman PICKLE. Mr. Bono.

STATEMENT OF JACK BONO, PRESIDENT, UNDERWRITERS LABORATORIES, INC., ACCOMPANIED BY JOE BHATIA, ASSISTANT TO THE PRESIDENT

Mr. BONO. All right. I am Jack Bono, president of Underwriters Laboratories, UL. With me is Joe Bhatia, in charge of our Washington, DC office, which works with government agencies on safety matters. Our statement addresses only one option and that is the option relating to testing for public safety.

When UL was formed 94 years ago, it had one purpose, by scientific investigation to reduce injury, loss of life and property damage. We have never departed from that mission.

The way we did it in the early years was fairly straightforward. We conducted safety engineering evaluations on products. If they met safety requirements, we inspected production periodically at the factory and the products were authorized to carry the distinctive UL mark.

As a safety system began to evolve in the United States, UL's role could no longer be confined to these basic functions. UL had to assume responsibilities required by the safety system, responsibilities shouldered by no other laboratory and let me list some: Develop products safety standards, 541 of them to date, and more to come; participate in development of building codes, the national electrical code and other installation standards, represent U.S. views in international standards committees, assist Federal agencies, State and municipal authorities; provide educational materials and information to schools and consumers; conduct essential safety research; assist U.S. manufactures in gaining acceptance of products in other countries.

UL's cost last year for these nonrevenue activities was approximately $10 million, but this is a necessary expenditure for UL to do what is expected of us.

Let me make a few additional points.

One, the few profitmaking laboratories who are now choosing to enter the product safety area do not provide this complete program. They pick and choose certain income producing areas of traditional UL work using UL standards and procedures while leaving to UL the nonincome activities.

Two, the UBIT issue has been characterized as a conflict between small business and nonprofit organizations. UL helps thousands of small businesses.

Three, in most countries, many of the functions carried out by UL are assumed by the National Government. If UL was forced to cut back on these functions because of a tax burden, either our Federal Government would need to assume them or public safety would be compromised.

And four, letters sent to Congress by Federal, State, and local government officials, by trade associations, by industry, by contractor organizations and other interests, support UL's role and urge that it not be diminished.

One more point: In our detailed comments we presented with some misgivings an alternate proposal. The proposal suggests maintaining the present exemptions for those activities specifically related to product safety certification, but taxing other activities even though they are safety-oriented, which are not for the express purpose of determining whether a product is eligible to bear a certification mark.

We cited examples of the latter activities carried out by UL on which taxes would be paid.

Although, UL's tax exemption would be restricted as compared with its present status, it would not require abandonment or major reduction of those programs essential to the interest of public safety.

UL plays a key role in the safety of over 12,000 types of products. We hope we will be able to maintain our concentration on public safety and not be diverted by a need to maximize profits. Thank you.

Chairman PICKLE. Thank you, Mr. Bono.

[The following was subsequently received:]

UNDERWRITERS LABORATORIES INC.®
333 PFINGSTEN ROAD · NORTHBROOK, ILLINOIS 60062–2096
an independent, not-for-profit organization testing for public safety

WRITTEN COMMENTS BY JACK BONO, PRESIDENT
UNDERWRITERS LABORATORIES INC.
REGARDING MAY 9, 1988 HEARING BY
OVERSIGHT SUBCOMMITTEE OF
HOUSE COMMITTEE ON WAYS AND MEANS ON
UNRELATED BUSINESS INCOME TAX (UBIT)

May 13, 1988

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

Subject: Supplemental Information on Discussion Option X Stating, "Modify Rules Applicable to Organizations Testing for Public Safety"

Dear Mr. Leonard:

In accordance with Press Release #18, we understand that supplemental written comments for the printed record relating specifically to the May 9, 1988 hearing are permitted to be submitted prior to May 23, 1988.

Mr. O. Donaldson Chapoton, Assistant Secretary-Tax Policy, U. S. Department of the Treasury, indicated that the rationale for the adoption by Congress in 1954 of the exemption involving "Testing for Public Safety" was not available. He suggested a further study of this issue before proceeding. Subsequently, during the question and answer session that followed my testimony, a Subcommittee member also solicited information in this area. For the sake of brevity, the complete information could not have been presented during the verbal discussions. However, we have prepared the attached statement in an effort to assist in the clarification of this issue for the U. S. Department of the Treasury. We would like to also enter these statements for the printed record relating specifically to the May 9, 1988 hearing held by the Oversight Subcommittee.

Very truly yours,

Jack Bono

JACK BONO
President
Underwriters Laboratories Inc.

JAB:AGA

Attachments

Look For The UL Listing or Classification Mark On The Product

Phone: (312) 272-8800 MCI Mail No.: 254-3343 Cable: ULINC NORTHBROOK, IL MCI Telex No.: 6502543343 FAX No.: (312) 272-8129

UNDERWRITERS LABORATORIES INC.
333 PFINGSTEN ROAD · NORTHBROOK, ILLINOIS [illegible]
an independent, not-for-profit organization testing for public safety

May 12, 1988

The Honorable O. Donaldson Chapoton
Assistant Secretary Tax Policy
U.S. Department of the Treasury
15th and Pennsylvania Ave., N.W.
Washington, DC 20220

Subject: Tax Exemption - Underwriters Laboratories Inc. (UL).

Dear Mr. Secretary:

I would like to compliment you on the very comprehensive presentation made to the Subcommittee on Oversight of the Committee on Ways and Means on the subject of Unrelated Business Income Tax. You clearly demonstrated an impressive grasp of some real complex issues associated with the discussion options proposed by the Subcommittee.

In your discussion of Option X involving modification of rules applicable to organizations "testing for public safety," you correctly indicated that this option in Section 501.c.3. of the IRS Code basically existed for one organization, namely Underwriters Laboratories Inc. (UL). You rightly observed that UL was organized as a non-profit organization and was tax exempt until 1935 as an organization operating for "scientific" purposes. Subsequently, the IRS ruled that UL did not fit the normal scientific category, even though our purpose and operations were unchanged, and removed the tax exemption. UL continued as a not-for-profit corporation but paid taxes until 1954, at which time UL was specifically excluded from paying taxes by Congressional action in including the "testing for public safety" exemption in the Code.

You suggested a further study of this issue since the rationale for Congressional action in 1954 in enacting this policy was not known to you and, consequently, the value of modifying the exemption was not presently determinable. Perhaps we can assist in providing some background and perspective on this issue.

When UL was formed 94 years ago, it had one purpose - by scientific investigations to reduce bodily injury, loss of life, and property damage. This purpose was implemented in the early days by safety engineering evaluation and testing of products in the laboratory. If they met safety requirements, we inspected production on a periodic basis at the factory and the products were authorized to bear the distinctive UL Mark.

As Federal, State, and local governments began to assume responsibility for the safety of citizens, and as consumer awareness grew, a safety system developed in the U.S. That system involved a regulatory function for the governments. It required development of installation codes, such as the

National Electrical Code and the Model Building Codes, for use by the enforcement officials. It necessitated the development of product standards that were compatible with the installation codes.

Each of the functions was required to be coordinated and made responsive to legitimate interests of regulatory officials, such as building and electrical inspectors, users of products, manufacturers, government agencies, and others. These functions were also impacted by international developments, such as the GATT Code and international standards.

UL's role in the emerging safety system could no longer be confined to testing and inspecting products. In order to be effective, UL had to become involved with these other functions and to assume responsibilities shouldered by no other laboratory in the United States. UL took on this role, which is now known as product certification, and it is for this function for which Congress, in 1954, revised the Internal Revenue Code to grant a tax exemption to non-profit organizations "testing for public safety."

This role, which we described in our written communication on this subject (a copy of which is attached for your reference), is what makes UL unique. For the sake of brevity, let me just state that our program includes many non-income producing activities which are described in our written communication and were also presented to the Subcommittee in my testimony on May 9. UL's cost last year for these activities was approximately $10 million dollars.

The circumstances that existed in 1954 that caused Congress to initiate this wise policy are equally if not more valid today. In 1954, UL was faced with a need to acquire equipment and facilities to meet technological developments which spawned many new and innovative products whose hazards and risks needed to be evaluated. Research had to be conducted. Standards for such products had to be developed. The Federal Government expanded its role in safety and agencies sought and received assistance from UL. Various state and local governmental authorities, fire inspectors, and electrical and building officials needed and received UL's help and assistance in carrying out their regulatory and procurement responsibilities.

Today, those needs and demands on UL have increased exponentially. The pace of technology and new developments is far greater than 1954. Electronic devices, computers, sophisticated medical equipment, communication components, and integrated circuits require approaches and test facilities far more sophisticated and expensive than in 1954. New demands have been placed on UL, such as representing U.S. views in international standards committees and seeking harmonization of U.S. standards with those of other countries, so as to eliminate barriers to trade. This is a natural responsibility since UL develops the product safety standards (541 to date) which are adopted as American National Standards.

In most countries, many of the functions carried out by UL are assumed by the national government. In the United States, no Federal agencies have the responsibility, expertise, or willingness to get involved in product safety certification and the associated activities that UL is required to assume.

On the contrary, considerable assistance is sought and provided at no cost by UL's safety experts to the Occupational Safety and Health Administration, the U.S. Consumer Product Safety Commission, the Department of Defense, General Services Administration, U.S. Coast Guard, U.S. Trade Representative's Office, and other Federal agencies.

When the U.S. Consumer Product Safety Commission had concerns about field failures and product malfunctions, and felt that standards needed to be revised or safety research was needed, they contacted UL.

When the Federal Bureau of Investigation needed to develop safety evaluative techniques for new and technologically sophisticated fingerprint identification systems, they contacted UL.

When a Fire Marshal in Florida needed to have someone develop technical data and produce a safety standard on smoke detectors for the hearing impaired, he contacted UL.

When an electrical inspector in Pennsylvania had questions or concerns about one of the thousands of products that he regulates, he contacted UL.

When the General Accounting Office or a Congressional Committee needs technical assistance or guidance in safety matters, they contact UL.

When aluminum bat manufacturers in the United States required assistance in overcoming technical hurdles in selling their products in Japan, they contacted UL.

When the computer industry wanted to harmonize U.S. safety standards with the international standards covering their product lines, they contacted UL.

When consumers and users wanted to be educated or wanted information in public safety matters, they contacted UL.

It is UL's position that for the reasons stated above, amplified in the attachments submitted with this letter, the exemption for "testing for public safety" should continue. The impact on public safety of the elimination of this exemption would be significant and negative. It would certainly impede UL's ability to respond to the need for safety evaluation of new and innovative products in today's fast-paced technologically changing environment.

As in 1954, today UL deserves its status because it occupies a unique role in the safety system in the United States, a role that includes a comprehensive program with responsibilities not assumed by any profit-making laboratory. Any reduction in UL's ability to carry out these safety responsibilities will result, in our view, in the need for the Federal Government to assume them or, more unfortunately, a reduction in public safety. This view is shared by others in the safety community, as expressed in letters referred to in the attachments. You will note that UL's role and tax exemption are supported by such diverse interests as the International Brotherhood of Electrical Workers, National Electrical Contractors Association, International Association of Electrical Inspectors, Federal agencies, state and local regulatory individuals, manufacturers, and others who have important roles in the U.S. safety system.

Although the "testing for public safety" exemption was adopted with Underwriters Laboratories in mind, it does not prevent other organizations who are willing to carry out safety responsibilities as their only mission and who are willing to operate as a non-profit organization from qualifying. It says something that others have not chosen to take on the responsibilities and make the total commitment to public safety.

After you and your staff have had a chance to review the material supplied here, we will be glad to meet with you to answer any questions or further explain and clarify the information presented.

Respectfully yours,

Jack Bono

JACK BONO
President

JAB:sb

Attachments

CC: Mr. Robert I. Brauer
Mr. Howard Schoenfeld
Mr. Joe Bhatia

[ATTACHMENTS TO THIS LETTER WERE PREVIOUSLY PRINTED IN THE COMMENTS ON DISCUSSIONS OPTIONS (WMCP 100-30) AND THE EXHIBITS ARE BEING RETAINED IN THE COMMITTEE FILES.]

Chairman PICKLE. Mr. Salisbury, you are presenting testimony in behalf of the architects or——

Mr. SALISBURY. No, sir. The Pension Realty Advisory firms.

Chairman PICKLE. Then you do not speak in behalf of the architects, but instead, the pension group.

Mr. SALISBURY. Yes, sir. I can't even draw a straight line.

Chairman PICKLE. We have heard representatives from your industry claim that most unrelated debt finance transactions, particularly real estate pension funds and educational institutions are not involved in the 100-percent leveraged transactions.

In fact, in practice, equity contributions are often higher than the 20 percent required under this discussion option. Why are you then so concerned? The general practice is when there is a minimum of 20 percent, why are you so concerned?

Mr. SALISBURY. Because I think, No. 1, in a given transaction rules of prudence ought to determine what the appropriate ratio of debt to equity is. In many cases, from the investor's point of view, an investor can minimize its risk if it can find someone else to put more debt in. I don't see any reason why they should be disabled from doing that.

The other point I would make is it sort of depends on when you look. It is quite common in a real estate investment to hold such investments for 10, 15, 20 years, and, in fact, there should be a great deal of normal growth in the value of that project. At some point, 10 years from now, it might be entirely possible for the investor to get all of his capital he originally put into a deal out of a deal through refinancing, and still have a very conservative loan to value ratio.

I think it is not appropriate—it seems not to be an appropriate matter to get into.

Chairman PICKLE. I can understand why you might not want to figure in it. You would like to have none in it, not put up any money in it, but you make the statement that it was unworkable. Why is it unworkable?

Mr. SALISBURY. I think it is unworkable because a variety of our transactions involve partnership rules. When you layer on the rules in 514(c)(9) with the partnership allocation rules, particularly the rules in 704(b), you can't do transactions that are protective of the tax exempt investor that comply with the requirements of 704(b), and still meet the rules that have been recently imposed in 514(c)(9). We are having a great deal of difficulty understanding what the evil is that the 514(c)(9) rules are setting out to overcome.

It seems to us that by and large any evils that might have existed were more than adequately taken care of by the provisions in the 1986 act. The partnership provisions, the passive loss rules, and all those things put in the code in 1986, which really took any evils if such there be out of real estate investing.

These are sort of new, simple things that are there without a lot of reason, it seems to us.

Chairman PICKLE. Well, you said that day there are federal and state laws that prevent pension funds, or pension fund investors and the like from unlimited leveraging. That is having too much debt upon entering into new transactions.

Mr. SALISBURY. Yes, sir.

Chairman Pickle. And you agree.

Now, could you explain then how States and the Federal Government control a number of debt financed transactions entered into by tax exempt entities.

Mr. Salisbury. Begin with the Federal. All of the corporate pensions plans are subject to ERISA. ERISA contains a requirement that investing be done prudently. Among the considerations of prudence is the debt to equity ratio. There is ample control, we believe, at the Federal level with respect to that large segment of the universe that is controlled by ERISA. There are already rules in place.

Chairman Pickle. It says prudent investment. You object to having any specific sum in there. Why?

Mr. Salisbury. The reason, sir, is because it seems to us that the—Congress has decided it is good, certainly permissible, for tax exempts to have leveraged investments. If you have investments in real estate and utilize leverage in connection with the investment, the determination of how much leverage is appropriate in a particular transaction depends on the transaction.

It may depend on what other kinds of investments that particular pension fund has in its portfolio. It depends on facts and circumstances, and there are constraints and we need to be worried about whether pension plans or their advisors are going to do the right things. There are a variety of State requirements of law that require fiduciaries to invest prudently in behalf of these kinds of people.

There is ERISA, and the issue is not whether it is 10 or 20 or 100 percent, but whether it is a prudent investment. That depends on the circumstances.

Chairman Pickle. Are we requiring a 20 percent investment figure? Are you saying that might not be prudent?

Mr. Salisbury. In some cases it may not be high enough. you have to analyze the risk and reward profile, the available cash flow, to determine what happens to be prudent. That really, it seems to us, is not a matter of tax policy.

Chairman Pickle. You are saying that a 20 percent might not be prudent. Isn't it a good investment if we had a 20 percent down payment instead of zero down payment.

Mr. Salisbury. From the investor's point of view, if you can find a lender that would take 100 percent of the risk and you were able to get and still retain a substantial portion of the rewards, that that would be probably quite a good investment.

Chairman Pickle. Mr. Thomas.

Mr. Thomas. I understand, Mr. Salisbury's concern. I possibly share it. Your area is a little different than some others. AIA, what are your concerns specifically? Where are the traps as far as you are concerned with some of the suggested changes on the UBIT?

Mr. Marines. The potential for taxing materials sold by AIA seems to be a pitfall for us. Many of our sales are accomplished through State and local chapters of the institute. Those are sales of the same materials which are sold here in our headquarters for the same educational purpose, to assist in the development of the practice of the profession. Because those are the same materials sold only by chapters of ours, it concerns us that those chapters may be subject to tax.

Mr. THOMAS. We have been concerned with universities, colleges and bookstores; museums, the little book store inside the museum, onsite versus offsite. Your problem is you don't really have what amounts to an onsite and almost all of your sales are offsite. If we wrote that section in a way that tried to do some things to change the patterns in museums and universities, that you would be swept in with them.

Is that your concern?

Mr. MARINES. That is correct.

Mr. THOMAS. Do you have any other concerns.

Mr. MARINES. The concern I expressed about the potential or omission from this legislation of tax on investment income creeping up elsewhere is also a concern.

Mr. THOMAS. Do you have a problem with the royalties?

Mr. MARINES. To the extent that monies are earned passively with no activity on behalf of AIA to create a commercial enterprise. We believe that those revenues should be tax exempt.

Mr. THOMAS. You have got your handbook. How often do you update that?

Mr. MARINES. A complete update happens once every 10 years. There are periodic updates of chapters as the profession changes.

Mr. THOMAS. Who does the updating?

Mr. MARINES. The bulk of the work is done by volunteers of AIA, member architects without compensation. Editing is done by the headquarters staff. That is 10 percent of the effort, perhaps.

Mr. THOMAS. Do you publish the handbook?

Mr. MARINES. Yes. It is——

Mr. THOMAS. AIA publishes the handbook?

Mr. MARINES. That is correct.

Mr. THOMAS. You have no private publisher?

Mr. MARINES. No, sir.

Mr. THOMAS. Mr. Bono, you were created in the 19th century.

Mr. BONO. 1894.

Mr. THOMAS. All was well and good up until 1943.

Mr. BONO. I think it is good now.

Mr. THOMAS. What happened in 1943?

Mr. BONO. In terms of tax exemption, I think it was correctly stated this morning by the representative from the Treasury Department. We had our tax exemption as a result of being in the category of a scientific institution, not for profit, and for some reason the IRS in 1935 actually ruled that we didn't fit the category of scientific any longer, even though our purpose hadn't changed, and we contested that but lost. So we started paying taxes, and that continued until 1954.

Mr. THOMAS. You started paying taxes and playing politics, because in 1954 when it was revised, a phrase, "testing for public safety," was added. Did you participate at all in making sure that that was added to the code?

Mr. BONO. I did not personally participate.

Mr. THOMAS. Underwriter Laboratories participated.

Mr. BONO. Our President, Mr. Brandon, at that time, involved himself with Congress in defining what it was Underwriters Laboratories did and recommended that it be tax exempt.

Mr. THOMAS. You indicated there were a number of things you did such as representing the United States outside the United States in dealing with standards established either internationally or with other countries?

Mr. BONO. Yes.

Mr. THOMAS. Are you officially charged as a representative of the United States. Do you carry some kind of papers?

Mr. BONO. We are delegated in those responsibilities through an organization called the American National Standards Institute, which is the official organization for coordinating standards in the United States. You need to be delegated by that organization in order to participate in that activity.

Mr. THOMAS. You engage in essential research. Who defines essential?

Mr. BONO. Essentially, I guess we define what is needed in the way of research in order to solve a safety problem.

Mr. THOMAS. So that is a self-definition of essential. The United States does not assign you to do essential research, the U.S. Government?

Mr. BONO. Some agencies of the Federal Government have requested that we do research work dealing with hazards, dealing with safety problems and under those circumstances we have carried out those programs.

Mr. THOMAS. How were the years 1943 to 1954. Did you survive, did you grow? Did you decline?

Mr. BONO. We grew at a fairly slow rate in those years. Our whole history has been one of subtle growth.

Mr. THOMAS. What could you not do that you are doing now if you returned to the 1943 to 1954 period?

Mr. BONO. UL has had to assume quite a number of responsibilities in order to fulfill its role in the safety system. Many of those responsibilities and activities produce no revenue, but we think it is necessary for us to carry them out, to be a proper partner in this system. We would have to look carefully at those nonrevenue producing activities and determine which we would have to diminish if we were faced with a tax burden.

Mr. THOMAS. The Treasury talked about taxing net investment. Do you have a position on taxing net investment?

Mr. BONO. I think Underwriters Laboratories has always tried to take a reasonable position. Maybe it comes from our history of having always to work in trying to make tough decisions between safety and cost benefit aspects, and we proposed an alternative that we thought may be worth consideration by this committee. So far as taxing of investment income, obviously we wouldn't be real excited about that because that helps to contribute to the dollars that we accumulate and further invest in safety matters. But if it is done, obviously, we will survive.

Mr. THOMAS. How much net investment income does UL have?

Mr. BONO. About $3 million.

Mr. THOMAS. Out of?

Mr. Bono. We have a gross income of approximately $160 million.

Mr. Thomas. How much income do you earn from your role, quasi official, developing safety standards versus performing tests to allow folks to apply the UL symbol to their electrical cord?

Mr. Bono. Essentially we earn no income in the development of standards. We do have an income of approximately a half a million dollars from a sale of the standards themselves, but that nowhere compensates us for the approximately $6 million that we spend annually for development of U.S UL product safety standards.

Mr. Thomas. What portion do you develop from the certification of products?

Mr. Bono. About almost all of our income is from the certification activities. So we basically are talking maybe of a total of $160 million, perhaps all but $1 million, so—that is not quite correct. Let me correct that. There are a number of safety activities that are associated and conducted by UL.

Most of them involve the certification. That could be 97 percent, 98 percent or so of our income. We also do certain sponsored research, for example, industry, or some government research is funded if the agencies have the money, and that does not lead directly to certification, but that is an amount that is in the range of perhaps a half million up to a maximum of about $2½ or $3 million per year.

The average would be less than $1 million per year on that type of activity.

Mr. Thomas. Thank you very much.

Chairman Pickle. Let me ask—yes, sir, Mr. Marines.

Mr. Marines. If I may clarify my answer to Congressman Thomas when you asked about my handbook and if AIA was the sole publisher, the answer is, yes. You may have had reference to our architectural standards or other primary publications sold in conjunction with Wylie Commercial Publisher on which we receive passive royalty income.

Mr. Thomas. How often is that updated?

Mr. Marines. About every 10 years.

Mr. Thomas. Donated labor from folks.

Mr. Marines. Yes, sir.

Mr. Thomas. Why do you publish the one and not the other then?

Mr. Marines. The "Handbook of Professional Practices" is something which is an AIA solely generated activity. The right to publish the architectural graphic standards was deeded to a joint venture of Wylie and ourselves. That was a choice made by the organization which deeded it to the partnership.

Mr. Thomas. You can take it back.

Mr. Marines. We don't have that right under the law to take that back. We are shared owners of that enterprise.

Mr. Thomas. You can buy it back.

Mr. Marines. If we can afford that, yes, sir.

Mr. Thomas. How did you get into the situation of sharing publication on one and not on the other?

Mr. Marines. In the case of the handbook, we were the originators. In the case of the Architectural Graphic Standards, that was originated by another organization which decided who would carry forward and they decided joint venture was the preferred approach.

Mr. THOMAS. You picked that up as a function of AIA. You didn't originate it.

Mr. MARINES. No, sir.

Mr. THOMAS. Thank you.

Chairman PICKLE. You consider the publications of these AIA contracts and forms part of your exempt purpose?

Mr. MARINES. Yes, sir, I do.

Chairman PICKLE. If you do, in what way would the discussion option change that?

Mr. MARINES. The option of taxing those contracts sold offsite would yield taxable income from our chapters.

Chairman PICKLE. I don't know that we have made any specific recommendations or discussion options in that area. You want to be sure we do not. Is that your purpose?

Mr. MARINES. Yes, sir.

Chairman PICKLE. You are taking out a little insurance?

Mr. MARINES. As much as we can get, sir.

Chairman PICKLE. I have one other question of Mr. Bono. This morning, he pointed out that Congress in 1954 adopted the testing for public safety exception. It is in operation now. The law didn't say why they granted that exception. They just made that exemption. It is still unclear. He made the statement this morning that the reason for it was that the treatment of such organizations was different from that of other 501(c) organizations.

Expressly exempted from classification is private foundations and thus he says that contributions, requests or gifts to them are not deductible. Since the income of such an organization is not dedicated to a charitable purpose, he said it may be appropriate for Congress to consider taxing their investment income periodic.

I assume you disagree with that. Do you?

Mr. BONO. It would certainly limit our ability to meet the safety challenges that I think we will face.

Chairman PICKLE. If it would limit it, let's say that if we took the phrase, "testing for public services," and if that were just taken completely out of the code, could you be exempt on any other category of 501(c)(3).

Mr. BONO. I don't believe so.

Chairman PICKLE. Then you need to be, from your standpoint, be kept in the code or otherwise you couldn't qualify.

Mr. BONO. I think that is what it comes down to.

Chairman PICKLE. I don't think I have any other questions. If any other member doesn't, we will conclude this panel. Have you been here for all of it this morning?

Mr. BONO. Yes.

Chairman PICKLE. It has been a long, drawn out series of panels, and I think the testimony we have gotten has been very helpful. I want to repeat to you and others that we started off with discussion options.

There are not any specific recommendations per se. I was pleased to get the Treasury's general endorsement of what we were doing in the main. Treasury is looking for further guidance and clarification on how to proceed. That doesn't mean that Treasury is in agreement to what you are recommending or vice-versa. It does mean that they are asking us to give further clarification on it.

The subcommittee is going to take only these reports and all these analyses and statements and make further study of them. We do not have a schedule at this point on how or when we will proceed. We hope we can make an analysis reasonably soon and pass it on to the full committee.

At any rate, I think we have had good testimony today, and I appreciate you coming and we will be in touch. Thank you very much. The subcommittee is adjourned.

[Whereupon, at 4:05 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF
TOMMY R. MCDOUGAL
PRESIDENT
ALABAMA HOSPITAL ASSOCIATION

I am Tommy R. McDougal, President of the Alabama Hospital Association (AlaHA). On behalf of the thirty eight (38) not-for-profit hospital members of the Alabama Hospital Association, I appreciate the opportunity to submit comments on the discussion options regarding the unrelated business income tax (UBIT) under consideration by the House Ways and Means Oversight Subcommittee.

The ability of Alabama not-for-profit hospitals to continue delivering high-quality health care to our patients and the communities they serve would be in serious jeopardy if these options are enacted. In fact, the Association has serious reservations about a number of the Subcommittee's discussion options, and urges the Subcommittee to give careful, studied consideration to each and their consequent effect on the delivery of health care before recommending changes in the UBIT law.

Most importantly, the Association believes that the Subcommittee's discussion options are very pervasive. They attack every aspect of the revenue stream relied upon by our not-for-profit hospitals and represent a total overhaul of the way they operate. The options will have a severe impact on our not-for-profit hospitals' ability to serve their exempt purposes and, ultimately, their patients.

THE MISSION OF NOT-FOR-PROFIT HEALTH CARE PROVIDERS

It is essential that the Subcommittee examine UBIT-related questions in the context of a clear understanding of the special health care mission of the voluntary, not-for-profit health care provider and the increasingly complex and challenging environment in which they must carry out that mission.

Not-for-profit health care institutions have provided access to health care for those unable to pay by employing community volunteers, soliciting community charitable donations, and cross-subsidizing those services provided at no fee or at a reduced fee or are otherwise inadequately reimbursed with fees charged other patients for other services. Data from the American Hospital Association show that 73% of hospital uncompensated care is provided by nongovernmental, not-for-profit hospitals. The cost of providing uncompensated care in Alabama has grown to $260 million annually, or 12% of their total expenses.

The not-for-profit hospital has been accorded special tax status because of its commitment to a broad range of charitable purposes and essential community responsibilities. The goal of the voluntary community hospital is to maintain and improve the health status of all of the citizens in its community by offering whatever health care services are needed, irrespective of whether or not the recipient can pay or whether the costs of such services can be recovered. The community service commitment of voluntary hospitals also frequently includes, in addition to providing personal health care services, major responsibilities for the training of health care professionals, the conduct of research to improve the quality of medical knowledge, and the health education of patients, their families, and the community at large.

The reasons for which hospitals engage in activities outside their traditional role of providing inpatient care are many. These activities are, and must be, ultimately in furtherance of the tax-exempt purpose and goal of all hospitals - the promotion of health. The public's interests are served when hospitals go outside their role of acute-care providers to operate or cooperate in diversified activities within the health care arena.

To the extent that there are surface similiarities with for-profit business and health care providers today, these result primarily from the enormous pressures from the Federal Government and private sector payors to become more "competitive." It would be ironic indeed if the Congress were to alter the tax treatment of not-for-profit institutions because of perceived similarities with the for-profit sector, when the Federal Government has created or encouraged the principle environmental changes which have led to this change in the surface appearance of our institutions.

Over the past few years, the Federal Government has proceeded to force further major economies in the health care sector by reducing annual Medicare payment increases below the increases in the prices of hospital inputs. Last year the Congress also reduced payments for hospital capital expenditures below actual costs. Because of these influences, and in order to survive, not-for-profit hospitals must be engaged in "income-producing" activities. Virtually any tax-exempt organization which is not engaged in such activities in today's environment of shrinking charitable giving and government reimbursement may not be able to perform its exempt purpose.

THE UNRELATED BUSINESS INCOME TAX

In 1950, Congress enacted legislation that imposed the unrelated business income tax, a tax on income from activities not substantially related to the tax-exempt organization's purpose. This legislation was to address a perceived unfair competitive advantage enjoyed by certain tax-exempt organizations and to prevent a potential loss of tax revenue. The tax was not imposed on income derived from any activity related to an organization's exempt purpose regardless of its competitive nature.

In enacting the UBIT law, Congress did not intend to eliminate all competition between tax-exempt and tax-paying entities. Rather it recognized that tax-exempt organizations may engage in income-producing activities in furtherance of their exempt purposes, and that this should be allowed without taxing the income from these activities if they meet the test of relatedness to the organization's exempt purpose. Indeed, Congress permitted tax-exempt entities to engage even in activities unrelated to their exempt purpose as long as tax is paid on the income from such activities and the activities do not constitute a substantial part of the activities of the exempt organization.

The Association has always supported this approach. We believe that it accurately reflects the reality that there are a wide variety of exempt activities being conducted by tax-exempt organizations today, and that these activities and their implications change over time. The fact that the UBIT law has functioned so well, despite the great changes in health care needs and the health services environment is strong evidence that the criteria of the UBIT test and the way it is implemented is appropriate.

It is worth repeating that UBIT was not intended to have an effect on the tax-exempt status of qualified organizations, nor does it preclude such entities from engaging in certain kinds of activities. But, it is intended to impose comparable taxes on unrelated commerical activity that are comparable to those imposed on taxable entities. The Association thinks this is appropriate.

THE "SUBSTANTIALLY RELATED" TEST

The Association has serious reservations about the Subcommittee's proposal to eliminate the "substantially related" test and replace it with a "directly related" test. Equally disturbing is the option to retain the "substantially related" test, but to impose UBIT on specified activities (i.e., "unsafe harbors") whose nature and scope are inherently commerical, rather than charitable.

These changes would call for the application of the UBIT to gift shop sales (with exceptions for articles generally used by or for inpatients); to all sales or rental income of medical equipment and devices, laboratory testing, and pharmaceutical drugs and goods (with exceptions for inpatients, continuous-care outpatients, or emergency treatment patients, or items not available in the immediate geographic area); to income from certain health, fitness, and similar activities; to adjunct food sales (with exception for on-premise services); to hotel facility income which is patronized by the public; and to additional specified activities determined to be "inherently commercial."

Under current law, the test to determine whether a business activity is or is not "substantially related" requires an examination of the relationship between the business activities which generate the particular income in question and the accomplishment of the organization's exempt purpose. The activities which generate the income must contribute importantly to the accomplishment of the organization's exempt purposes to be substantially related.

During testimony to the Subcommittee on Oversight on June 22, 1987, the Treasury Department acknowledged that the "substantially related" test has "conceptual merit" but expressed reservations about "its inherent generality [as] a source of administrative difficulty." Instead of abandoning the substantially related test, the Treasury Department recommended "obtaining more detailed information concerning the revenues of exempt organizations and the basis of treating them as tax exempt."

We agree. The alleged abuses in this area do not justify the abandonment of the "substantially related" test for other tests, such as whether the activity is "directy related," whether the income producing activity standing alone is tax exempt, or whether the activity is inherently commerical (as defined by the unsafe harbors) or charitable.

These tests are at least as subjective as the substantially related test; any such change in the language of the test would result in years of uncertainty as new interpretations define the contours of the new standard. Moreover, it is extremely unlikely that any reduction in competition with for-profit businesses or increased UBIT tax revenues would justify the costs to both tax-exempt and taxable businesses of changing the test.

The Association believes that more effective application of the existing "substantially related" test is preferable to the development of some new subjective untested standards. Also, improved enforcement by the Internal Revenue Service and more detailed compliance by the tax exempt sector would be a more effective approach to concerns raised in this area.

THE "CONVENIENCE" EXCEPTION

The Subcommittee also proposes to repeal the "convenience" exception. Under current law, any trade or business carried on by a Internal Revenue Code 501(c)(3) organization primarily for the convenience of its members, students, patients, officers, or employees is not unrelated trade or business. The Association believes that the convenience exception makes good sense and should not be repealed. Conveniences such as employee cafeterias, vending machines, gift shops, pharmacy, parking lots, staff residences, etc. are not provided to the hospital's staff, students, physicians or patients because they produce revenue. Rather, the services are provided because they contribute importantly to the functioning of the hospital. These conveniences certainly enhance the delivery of health care services to our patients.

Establishing new, complex rules to determine whether specific transactions are related to specific kinds of patients (e.g., the patient is an inpatient, the patient is a "continuous care" outpatient, etc.) is unwarranted and unnecessary, and would impose additional administrative burdens on hospitals and the government.

Finally, there are a number of other ambiguities contained in the Subcommittee's proposals which signal caution. One example is the Subcommittee's use of the phrase "continuous care" outpatient without specification or definition. The application of UBIT to income generated from sales to such individuals would appear to be overreaching and overly broad without a concise and applicable definition of the terms.

TAXATION OF SUBSIDIARIES

Perhaps the Subcommittee proposals that generate the most concern among the not-for-profit hospitals in Alabama are those regarding subsidiaries and joint ventures. The Subcommittee proposes to modify the definition of "control" in the case of exempt organizations having taxable subsidiaries; extend the "control" rules where exempt organizations in the aggregate own more than 50% of the subsidiary's stock; provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt organization; and aggregate income and activities of controlled subsidiaries for purposes of determining if the primary purpose of the parent organization is a tax-exempt purpose.

Through the creation of for-profit subsidiaries, which pay taxes on their net income before the after-tax income goes to the not-for-profit hospital, our not-for-profit providers have been able to integrate into our total health care system certain services in which they otherwise would be unable to participate. This is because the amount of unrelated income from these services within the tax-exempt hospital would have jeopardized their tax exemption.

Present law allows taxable subsidiaries to offset income with losses from activities whether or not they could qualify for exempt status on their own. We believe this is fair and workable.

One of the Subcommittee's proposed options would provide that a controlled taxable subsidiary's income could be no less than its unrelated business income would have been if the income-producing activity had been carried on directly by the exempt parent organization. The effect of this option is very unclear, but it is potentially explosive. Tax exempt organizations would be placed at a tax disadvantage as a result; in effect, the government would essentially be collapsing the corporate structure for tax purposes and in a manner unfair to tax exempt organizations.

Moreover as written, the proposal would prevent the subsidiary from deducting at its level payments of interest, rents, royalties, (which are normally deductible expenses of a taxable business) even though those same amounts would also be taxable to the parent organization.

AGGREGATION

The Subcommittee proposes to aggregate the income and activities of controlled subsidiaries with the activities of an exempt parent for purposes of determining whether the parent's activities are primarily charitable. Where a taxable business is separately incorporated and its books and records are separately accounted for, we do not believe that there is any reason to treat such a business as if its activities were conducted directly by the exempt parent.

This change would affect not merely the net income derived from unrelated business, but the very exemption of the parent. Many exempt organizations, particularly in the health care field, have set up controlled taxable subsidiaries to conduct certain activities that would, in most cases at least, be subject to unrelated income tax if conducted directly. Under current law, doing so does not normally affect the tax cost (relative to direct operations), but it does insure that the subsidiary's activity cannot jeopardize the exempt status of the parent.

The proposed change would eliminate that "safe harbor." The practical effect of the provision would depend heavily on what definition was applied to determining whether a purpose is "primary." Similarly, the significance of the proposal would be determined in part by the rules to be applied in determining whether an activity of the subsidiary was related to the purpose of the parent.

JOINT VENTURES

Under current law, joint ventures are subject to a test of relatedness to the hospital's exempt purposes, and, if unrelated, to tax on the income from the venture. A number of hospitals in Alabama have reorganized to create a structure which typically includes a not-for-profit parent, a not-for-profit hospitals, and a not-for-profit foundation, and perhaps one or more affiliates, either not-for-profit or for-profit. There are several reasons for these restructurings. Where the new activities are subject to rules and regulations different from those applicable to acute care hospitals, the separation of these activities into discrete entities facilitates management and compliance with differing regulatory environments.

Among other things, joint ventures are an important method of creating and maintaining critical ties with alternate delivery and financing entities such as HMOs, PPOs, ambulatory clinics, home health programs, and ties with physicians or physician groups. Such ventures have important primary purposes other than revenue-raising, and not all joint ventures will involve the delivery of health care services. Examples include: a partnership with a group of radiologists to purchase a CAT scanner that hospital patients will use; a joint venture to open a drug rehabilitation clinic may be designed to ensure continued access to post-acute care services; a venture to purchase a medical office building near the hospital may have the multiple purposes of providing convenient access to physicians by patients, beneficial proximity of physicians to the hospital, as well as a source of revenue.

The Association believes that these types of responses to the increasing health care needs of the communities our not-for-profit hospitals serve are fully consistent with our hospital's charitable purposes. Indeed, they are in some cases necessary to perform the hospital's mission.

The Association believes that the hospital industry's structuring of activities as joint ventures is, and should continue to be, appropriately subject to the current unrelated business income provisions. It is important to the future of high quality health care delivered at reasonable costs for hospitals to have the flexibility in structuring diverse activities to respond to community needs, to attract patients, and to use their facilities efficiently.

ALLOCATION RULES

When a tax-exempt entity engages in an unrelated trade or business, current law provides that the gross income derived from such activity (less allowable deductions "directly connected" with the carrying on of such business) will be computed for Federal income tax purposes as if it were a taxable business. Regulations provide that where facilities and personnel are used both to carry on exempt activities and to conduct unrelated business activities, expenses, depreciation and similar items, like overhead, are to be allocated between the two uses on a reasonable basis. These standards, which are both fair and practical, serve the purpose of placing the exempt organization, as to its unrelated activities, on par with taxable business.

The Subcommittee option suggests two particular accounting changes: one that would require allocation of expenses based on theoretical potential use rather than actual use of facilities; and the other to limit the aggregate deductions available with respect to an unrelated business activity. Specifically, the Subcommittee provides with respect to facilities used for exempt purposes as well as unrelated business purposes, a deduction against UBI for a proportionate share of the direct-operating cost of the facility (e.g., maintenance, insurance, and utilities), but does not allow a deduction for a share of the general overhead of the organization or for depreciation.

The Association objects to both. The option suggested would not achieve parity with business (which are permitted to allocate expenses between activities on an actual basis) but instead would unfairly penalize exempt organizations which attempt to limit their costs by permitting external access to expensive equipment or facilities.

TAX INFORMATION REPORTING/INTERNAL REVENUE SERVICE (IRS) ADMINISTRATION

The Association firmly believes that changes to the unrelated business income tax should be based on hard information rather than anecdotes of abuse. Accordingly, the Association supports the Subcommittee's discussion options which expand the current reporting requirements imposed upon tax-exempt organizations. We urge the Subcommittee to use this data and information to carefully examine the impact that any change in the UBIT law may have on the administrative impact on hospitals. The Association supports the proposal to recommend that the Internal Revenue Service study nonprofit exempt hospital reorganizations (examining the purpose, effect of the use of subsidiaries), and the use, purpose, and effect of joint ventures. Only after these comprehensive studies are complete should the Congress proceed to consider making changes in the UBIT law.

CONCLUSION

The Association supports the current application of the UBIT law and pertinent regulations which allow necessary flexibility in responding to the crisis of change in which hospitals find themselves. In order to remain fiscally sound and in a position to deliver services to the community and provide charity care, hospitals must be able to engage in revenue-producing activities that are competitive and within fair, defined limits.

It would be detrimental to the delivery of high quality health care services to drastically change the rules governing the operations of tax-exempt enterprises, on which 85% of the nation's hospitals rely. Any change in tax policy that would decrease the ability of these hospitals to engage in appropriate revenue-raising activities would undermine the competitive model of health care and the promise of continued high quality services.

The Association believes that the current legislative, regulatory, and judicial treatment of UBIT as applied to not-for-profit health care facilities is appropriate; it is understandable, it is predictable, and it is workable.

In light of the current lack of complete data and other necessary information on the methods and types of activities that relate to this issue, as well as the nature and extent of the allegations of unfair competition that have been made, the Association urges that any action regarding unrelated business income tax provisions await the completion of the Internal Revenue Service audit now underway, and the completion of the suggested studies and additional data collection activities recommended in the Subcommittee's discussion options.

COMMENTS ON DISCUSSION OPTIONS RELATING TO THE UNRELATED BUSINESS INCOME TAX.

The Alliance Theatre Company, as a not-for-profit organization, is greatly concerned that discussions taking place regarding revision to the Unrelated Business Income Tax may threaten revenue producing activities of the Theatre and therefore threaten our ability to pursue our purpose. Regarding Press Release #16 of the Subcommittee on Oversight of the Committee on Ways and Means of the House of Representatives, I am writing to express our concern over some of the discussion options open before the committee.

The primary objective of the adoption of the Unrelated Business Income Tax (UBIT) was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete.

The need for a healthy and effective not-for-profit sector is apparent. Philanthropy and the not-for-profit system has evolved as an adjunct of, and as a supplement to, our economic system of private enterprise. The not-for-profit enters only where the for-profit has failed to provide economic incentive (profit) enough to satisfy and supply the public good. Charitable enterprises allow public services to be performed by a portion of the private sector instead of the government. Private initiative has proven on most occasions to be the most efficient means of insuring that appropriate action is taken.

In response to specific Discussion Options:

1. Repeal "substantially related" test and replace it with a "directly related" test.

Examining the relationship between an exempt organization and its business and trade activities, determination of a substantial causal relationship, implying that the activities relate more to the organization's exempt purpose than not, is adequate in deciding whether the imposition of UBIT is appropriate.

Substituting "directly" for "substantially" would restrict activities to only those that match letter for letter the organization's exempt purpose. It is conceivable that under such restrictions, a ballet company could not produce modern dance, a theatre could not do opera, and a library could not show slides of art work. A substantial relationship implies that, beyond doubt, a real and tangible connection can be made between the activities outcome and the exempt purpose of the organization. That test alone is enough to substantiate the real purpose of the activity as furthering the purpose of the organization.

Purposes defined as exempt are, for the most part, broadly defined by institutions to allow for, in the case of the arts, free range of interpretation and expression. Requiring a direct causal relationship would constrict the activities of arts organizations. And as result, many exempt purposes would be rewritten to further broaden the potential for direct relationships.

I.A. Apply UBIT to gift shop/bookstore income. In addition, apply UBIT to income from all catalog and mail/phone order or other "off-premise" sales.

Gift shops and bookstores provide a powerful means of displaying, promoting, and furthering the exempt purposes of an organization. Programs and activities can be further enriched by literature, reproductions, and items of interest that serve to multiply the benefits brought by a charitable organization.

Applying UBIT to income from catalog, mail/phone orders, or other "off-premise sales" will unduly constrain the public from receiving the exempt benefits of the institution. If that trade or business is exempt from UBIT, the technology by which that activity and purpose is transferred should not affect its status. Whether money is exchanged over the phone, through the mail, or in person should not effect the status of that income nor its relation to the organization's exempt purpose.

I.L Apply UBIT to additional specified activities determined to be inherently commercial.

Applying UBIT to additional specified activities determined to be "inherently commercial" seems to throw all concrete criteria out the window and in its place leave a very subjective and very dangerous precedent. Many activities conducted by exempt organizations are inherently commercial while being directly and inherently related to their exempt purposes. The simple exchange of ideas and resources within the marketplace defines commercial. Using the term as a definition and criteria for determining whether an activity is subject to UBIT is reckless.

Currently, an exempt organization's trade or business, that produces income from an activity not related substantially to its exempt purpose presents sufficient likelihood of unfair competition. As such, the income from that activity is subject to UBIT, the purpose of the UBIT being to establish a level playing field with no advantages for either for-profit or charitable institutions.

Many of the discussion options fail to take into account the necessity of different playing fields for different games. An organization is granted not-for-profit exempt status because it fills a need of the public good not filled by the for-profit sector. As charitable organizations become more and more efficient and adept at funding their exempt purpose, it is inevitable that they may cross into activities held by others to be the domain of the for-profit. However, if it can be proven that the activity of the organization is substantially related to that organization's exempt purpose, and that the activity furthers the support or existence of purpose, that activity should be exempt from UBIT since its relationship has been established.

In times of decreasing reliance on Federal funds for operating budgets, it is unhealthy to slap the wrists of institutions attempting to become more self-reliant. It is most important to remember that these institutions exist to further the public good and that this differentiation from the for-profit sector demands special consideration.

Respectfully submitted,

R. Scott Lane
Development Associate
Alliance Theatre Company
Robert W. Woodruff Arts Center
1280 Peachtree Street, NE
Atlanta, GA 30309

April 12, 1988

American
Association
of
Museums

23 May 1988

The Honorable J.J. Pickle, Chairman
House Ways and Means Subcommittee on Oversight
U.S. House of Representatives
1105 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

Re: Unrelated Business Income Tax - 9 May 1988 hearing

The American Association of Museums ("AAM") has testified before and submitted written statements to the Ways and Means Subcommittee on Oversight regarding the unrelated business income tax ("UBIT") on four occasions over the past year. Therefore, we do not believe it is necessary to submit an additional extensive comment to the subcommittee at this time, especially as we understand that last week the subcomittee began its mark-up process.

Nevertheless, the AAM would like to make a few observations for the hearing record. The first part of our comment focuses upon the general criticisms raised during the subcommittee's recent hearing. The second part of our comment focuses upon the rationale for evaluating the scope of UBIT as articulated by Assistant Secretary of the Treasury Chapoton.

During the May 9, 1988 hearing, several subcommittee members asked the following questions:

> Do museums run their stores and catalogues to operate at a surplus or a loss and if they do run at a surplus, is that not evidence of a commercial motive?
>
> How can the sale of certain "consumer items" be substantially related to the museum's tax exempt purpose?

The first question implies that stores and catalogues that run at a surplus are "too commercial" or "not really eleemosynary." In fact, museum stores and catalogues do not choose their inventory by what will sell best. If they did, museum stores would look like Bloomingdales or Wal-Mart. We acknowledge, of course, that inventory is selected because museums hope someone will purchase it. We believe museums fulfill their educational purpose by carrying objects of beauty and educational or historical value that will be attractive to the public and will circulate among the public.

The paradox hidden in the first question is that if museums shop and catalogue inventory were to be made broadly taxable such an approach would appear to be encouraging museums to become aggressively commercial In such a broad taxable environment, the standards of quality currently adhered to would be a damper on earnings, and museums might see that they would be financially better served by selecting an inventory solely on the basis of profit potential. We cannot believe that encouraging more commercial activity is the objective of the subcommittee.

The second question posed by several subcommittee members can be answered simply. The exotic objects upon which the subcommittee members concentrated during the hearing (and which represent a tiny handful of the items in the catalogue) are displayed in the museum's collection. As such, they are not merely related or substantially related. These objects have an even more

1225 Eye Street
Northwest
Washington DC
20005

Telephone
(202) 289-1818

direct relationship to the object on exhibit than an art print bears to a painting on exhibit. These objects are often one and the same; created from the same machine. In fact the object for sale can often be substituted for the object on exhibit. Therefore, to tax such sales is to repeal the rule of substantial relatedness.

Next we would like to turn to the testimony of Assistant Secretary Chapoton. The Secretary suggested that an analysis of UBIT involves consideration of unfair competition, economic efficiency and accountability. The question of unfair competition in the case of museum stores and catalogues can be answered briefly -- virtually no allegations of unfair competition have been made in three thousand pages of testimony and comment over six days of hearings. Thus, museum stores and catalogues pass the first Treasury consideration of UBIT.

The test of economic efficiency is whether the exemption encourages activities that provide the greatest social benefit. As we suggested above, the current UBIT rule of substantial relatedness does promote the greatest social benefit. The proof of this proposition is the very catalogues to which the subcommittee members referred in the May 9 hearing. In each case, these objects are unique examples of a type, and that uniqueness is the beauty of the design, colors of the materials that make up the object. In each case, other objects exist that perform the same utilitarian function as the object in the museum store, and have a much higher markup potential. The selection of the object to be exhibited in the collection and, consequently, sold in the store is not based primarily upon profit, but on standards of beauty and educational value as well. Hence, museum stores and catalogues satisfy the second Treasury criteria.

The test of accountability is satisfied when the commercial activities do not overwhelm the contributory and other traditional forms of support enjoyed by tax-exempt organizations. When the commercial activities become predominant, the potential for losing track of the organization's charitable purpose increases. In the case of museums, revenue-producing activities play a modest role in total support. Moreover, the public nature of museums strongly limits the possibility of ignoring charitable and educational purposes. Thus, museums also satisfy the third Treasury consideration.

A corollary issue raised by Secretary Chapoton is the correct treatment of objects that are "primarily functional" or "primarily decorative." The Secretary suggested, for example, that the sale of jewelry would be taxable because of its decorative nature. Similarly, the sale by an organization devoted to the study of Elizabethan England of an armchair modeled on one used in that era would be subject to tax because of its functional nature.

We believe that the Secretary's examples illustrate why standards of taxability based upon whether items are primarily decorative or functional are wrong for museums. A museum devoted to the history and culture of native Americans ought to be able to sell exact reproductions of 19th century jewelry contained in its collection. The beauty of the reproduction emphasizes its educational merit because it clearly demonstrates the achievements of the native American culture.

A museum devoted to the Elizabethan period that sells carefully selected productions of items in its collection (including an armchair) also is clearly furthering its educational mission of increasing awareness and interest in the period. In evaluating the importance of decoration or functionalism, the Department of the Treasury's failure to recognize the significance of reproducing collection items renders almost meaningless the concept of substantial relatedness.

We believe these comments have addressed both the theoretical issues raised by Treasury as well as the more visceral issues raised by subcommittee members during the hearing. We hope these comments are helpful to the subcommittee in understanding the special situation of the museum community.

Sincerely,

Ed Able

Edward H. Able Jr.
Executive Director

WRITTEN STATEMENT
OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

These written comments, which are being submitted on behalf of the American Institute of Certified Public Accountants (AICPA), were formulated by the Exempt Organizations Task Force and reviewed by the Executive Committee of the Tax Division.

In his testimony before this subcommittee on June 30, 1987, Mr. Herbert J. Lerner, the Chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants, stated that it was premature to proceed with any change in the area of tax-exempt organizations until such time as a comprehensive, well-reasoned framework for change can be designed. We believe, as Mr. Lerner stated in his testimony, that to design the proper framework should entail a review of the proper role of exempt organizations in our society, a long term study of the competitive issue, enhanced data collection on exempt organization activities, and a better understanding of the capabilities and limitations of the existing system.

While we believe it is premature to consider piecemeal changes, we enclose the following comments to provide the Subcommittee with additional information.

The purpose of these comments is to provide the Subcommittee with additional information, in the form of both questions and suggestions, to be considered when developing its recommendations for revisions to the existing tax law applicable to exempt organizations.

The AICPA believes that commercial activities should be subject to income tax whether or not those activities are conducted by otherwise tax-exempt organizations. However, we believe that only income from commercial activities and not "portfolio or investment income" should be subject to tax. In addition, we believe that the mere conduct of commercial activities should not provide a basis for denying exempt status to an organization. Finally, we believe that taxable income from business or commercial activities should be calculated in the same fashion for both taxable and tax-exempt organizations.

We commend the Subcommittee on Oversight and Chairman Pickle on their continued efforts to clarify topics affecting exempt organizations. The activities of exempt organizations have increased in recent years as the need for the services of these organizations has increased. In light of these changes, there has also been considerable interest on the part of the Treasury Department and tax practitioners, regarding unrelated business income and other issues affecting the tax treatment of exempt organizations.

These comments are presented in the format used by the Committee in its press release of Thursday, March 31, 1988.

I. "Substantially Related" Test

The "substantially related" standard has been criticized for its ambiguity. A "directly related" standard would seemingly be equally ambiguous. Further, ~~it~~ would not have the advantage of the nearly 40 years of interpretive precedent enjoyed by the "substantially related" standard. Also, we are not sure how such a definition would provide a consistent standard for taxing commercial activities not already taxable under current law. For example, what activities might be "directly related" but not "substantially" related?

For these reasons and from a standpoint of mere administrability, we recommend that the "substantially related" test not be abandoned for a "directly related" standard. Rather, we prefer the alternative approach suggested by the Subcommittee -- retaining the "substantially related" test but imposing unrelated business income tax (UBIT) on specified activities whose nature and scope are "inherently commercial," rather than charitable. This approach conforms to the pattern chosen by Congress in 1986 when it enacted section 501(m) to tax commercial insurance activities.

The following comments (A.- L.) address specific activities on which UBIT would be imposed as a result of the proposed change to the "substantially related" standards.

A. Gift shop/book store income

A clarification of de minimis off-premises sales is needed. Is an off-premises activity "de minimis" as long as it is "smaller" than the on-premises activity? In other words, can catalogue sales activity be excluded from UBIT even if it brings in $1 less in sales than the on-premises activity? What measurement base is used to compare the off- and on-premises activities for purposes of the de minimis rule? We suggest that gross receipts (net of returns and allowances) would be a more administrable standard than earnings because it avoids difficult expense allocation issues.

B. Medical equipment and devices, laboratory testing, and pharmaceutical drugs and goods.

Clarification of the term "continuous-care outpatient" is needed. Does this term include the patient who is rarely present in the hospital facility but is regularly attended to by hospital personnel in the home? Are persons who are administratively considered patients of an unrelated hospital or nursing home but receive physical therapy services from the exempt organization in question on a continuous basis (see LTR 8707041) included? Does it include persons receiving treatment on a regular basis from an outpatient weight control or smoking clinic operated by the hospital? Alternatively, a general standard might be substituted such as a but-for test requiring hospitalization were continuous outpatient care not available.

Who are a hospital's "inpatients?" Do they include admitted patients of a skilled nursing facility or residents of a nursing home organization affiliated with the hospital? Are admitted patients of an alcohol/substance abuse center operated by the hospital included?

How is the "immediate geographic area" exception to be applied? Is such an area defined in terms of objective parameters (e.g., no similar items are sold within a certain mile radius of the exempt organization) or in terms of competition with for-profit enterprises offering similar services (e.g., no commercial labs operate in a three-county area)? This "immediate geographic area" exception is so broad in its present form that the general response may be noncompliance.

If a nonpatient laboratory activity primarily accomplishes the educational objectives of a teaching hospital (rather than its charitable health care purposes), is it nevertheless taxable under the "inherently commercial activity" approach because similar services are available in the immediate geographic area (See Rev. Rul. 85-109, 1985-2 C.B. 165)?

C. Health clubs

Clarification is requested regarding the application of UBIT to an organization that charges a higher monthly and one-time membership fee, above the corresponding general membership fees, for the use of an exclusive section of its facilities. The organization makes the majority of the facilities available to the general public on a sliding-scale fee basis or by scholarship, based on affordability. Is the entire special fee subject to UBIT or just the amount in excess of the general membership fee?

D. Travel and tour services

What are "de minimis sales" to non-student/faculty? Is it restricted to spouses and/or companions of the student and faculty of a degree program or does the de minimis rule allow a college or university to commercially market a specified percentage of its tickets for a particular tour package to the general public without being taxed?

It does not seem equitable to provide an exception from UBIT for travel/tours that are truly motivated by educational interests without providing a similar exception for those truly motivated by religious, scientific, or other charitable purposes. In particular, the proposed option seems to discriminate between religious organizations which sponsor a university and other religious organizations that do not sponsor a university. The former may be able to "sanitize" their religiously motivated tours through the university exception and the de minimis rule while the latter organizations must pay UBIT on similar travel activities. Perhaps the exclusion could be broadened to encompass any travel or tour services provided to the sponsoring organization's members.

E. Adjunct food sales

Does the on-premises exception depend on whether food is sold or consumed on the exempt organization's premises? For example, would UBIT apply to sales of baked goods, pizza, or packaged dairy products to employees of a university or hospital for consumption at the employee's homes or otherwise off the premises of the organization?

What does "primarily" mean, and how is it measured for purposes of the on-premises exception?

Would UBIT apply to food services provided to the poor or elderly shut-ins notwithstanding a statutory provision taxing all off-premises food sales as "inherently commercial" activities (See Rev. Rul. 76-244, 1976-1 C.B. 155)? What if a hospital did not actually provide the meals to the poor or elderly but rather sold the meals to another exempt "Meals on Wheels" organization that provided the home delivery? What if the hospital contracted with a local government agency to provide meals to the agency which provides them to the poor and elderly?

Would UBIT apply to off-premises food sales by a non-profit organization that furthers religious purposes by assisting the individual members of a particular religion to observe dietary rules of that religion (See Rev. Rul. 74-575, 1974-2 C.B. 161)?

Situations such as the preceding examples underscore the inequalities that may result from treating specified activities as being "inherently commercial" and, therefore, subject to taxation as a matter of law, irrespective of any substantial relationship to charitable purposes.

F. Veterinary services

It is unclear how this provision changes current law.

G. Hotel facilities

This provision does not seem to provide any better guidance than the existing "substantially related" test because an exception is provided for facilities operated "in furtherance of the organization's exempt purposes" (See LTR 8246014).

In the case of hospital hotels, would UBIT apply in the case of non-family visitors, staff physicians, nurses, or members of a sponsoring religious order? If an exception were provided for a patient's family, how would the relationship be substantiated?

If an exception were made for university-owned hotels to the extent operated by faculty and students as part of a hotel management curriculum, how would earnings be allocated between curriculum and non-curriculum related activities? Labor hours attributable to faculty/students as opposed to professional management personnel might provide an appropriate allocation base.

Would an exception be provided for college/hospital hotels located in isolated geographical areas where members of the general public using the college or hospital facilities for an unrelated purpose could not find any other conveniently located accommodations? For example, persons attending a sales meeting at the university's conference facilities might seek lodging on campus facilities due to lack of any privately operated facilities convenient to the campus.

Is the exempt purpose exception determined based on the operation of the lodging facility itself or the nature of the activity bringing the lodger to the facility? For example, does the application of UBIT depend on whether a university-owned hotel is primarily operated as part of a hotel management curriculum or to provide part-time employment for students, or does it depend on whether a particular lodger stays at the hotel to attend an adult continuing education seminar or to attend a business meeting?

Does the explicit taxation of sales of condominiums ignore entirely the relationship of such sales to the organization's exempt purposes? For example, would the sale of condominium units in a medical office building to staff physicians be taxed to a hospital as UBIT (see Rev. Rul. 69-463, 1969-2 C.B. 131, and Rev. Rul. 69-464, 1969-2 C.B. 132).

H. Routine testing

Because the provision only excepts laboratory testing that is part of a student education training program, it would seem to apply UBIT to routine laboratory testing services (e.g., X-ray) for inpatients of a non-teaching hospital. Is this what is intended?

I. Income from affinity credit cards/catalog endorsements

This type of income should not be taxed because of the lack of commercial competition and also because the activity publicizes the name and therefore promotes the organization.

J. Advertising income and cost allocation rules.

Would the "per se" rule apply UBIT to advertising that is conducted once a year in conjunction with a fundraising event (See, for example, Rev. Rul 75-201, 1975-1 C.B. 164). Would the "per se" rule apply to advertising that is conducted with regard to an annual convention and trade show? Treas. Reg. § 1.513-3. If the per se rule is adopted, current regulations should be applied to determine the exempt portion of advertising income.

K. Theme/amusement parks

Would UBIT apply if a university or religious owned theme park were operated primarily to educate the public regarding the culture and arts of a particular region or certain ethnic groups and to provide employment for its students who were natives of such region or members of such ethnic groups?

L. No comment.

II. "Convenience" Exception

The "convenience" exception has not been used frequently to determine the characterization of income as subject to or not subject to UBIT. Several rulings have dealt with factual situations that would suggest the application of the convenience exception, but these rulings have made no mention of the convenience exception. Instead, the "substantially related" test has been used to determine that the businesses are related to the organization's performance of its exempt function. See Rev. Rul. 69-267, 1969 C.B. 160; Rev. Rul. 69-268, ibid., Rev. Rul. 69-269, ibid, and Rev. Rul. 74-399, 1974-2 C.B. 172. Because the exception has been little used, its repeal would not appear to have major impact as most decisions have used the "substantially related" test to determine the character of income.

III. "Regularly Carried On" Test

What will the effect of the repeal of the "regularly carried on" test be? Will the income generated from such activities be subject to tax on unrelated business income? Will the determination that income is generated by an activity that constitutes a trade or business be required to determine the taxable or non-taxable character of such income? Would there be de minimis (either of income generated or time involved in the activity) exception for having such income? If so, is this not a retention of a modified form of the "regularly carried on" test?

Regarding the repeal of the "regularly carried on" test, it should be made clear that if the regularly carried on test is repealed such repeal will not result in fund-raising events being subject to UBIT. Also, expanding judicial interpretation of the trade or business definition and repeal or modification of the "regularly carried on" test may effectively result in a single subjective "relatedness" test.

IV. Tax Treatment of Royalty Income

It is difficult to determine the rationale behind the Subcommittee's proposal to apply UBIT to royalties measured by net or taxable income. Why are such royalties inherently different from royalties measured by gross income or per item sales or production? Many tax-exempt organizations are able to derive otherwise unavailable sources of revenue by using net income royalty agreements because by entering into such an agreement the payor of royalties reduces his risk of loss. If the payor is not profitable, the tax-exempt organization does not receive any royalties. Because of the sometime tenuous nature and/or value of certain properties, the tax-exempt organization could not coax a business organization to enter into a gross income or per item royalty agreement. The inherent differences of these types of royalty agreements lie primarily with the payor, not the payee. Other than the generation of additional revenue, there is no apparent rational for the proposed change.

The second option to change the royalty exclusion rules would tax royalties if they were received for the use of property created by the organization, or if the organization (or a closely-related organization) either performed substantial services or incurred substantial costs with respect to the development or marketing of a licensed property. Royalties from self-created property or property with respect to which substantial services are performed or substantial costs are incurred should not automatically be subject to the UBIT. If the property was developed in furtherance of the organization's exempt purpose and the receipt of royalties is only a by-product of that development, the royalties are passive in nature and should not be subject to UBIT. In addition, if substantial services are performed by unpaid volunteers, the royalty income should retain its passive character and, again, should not be subject to UBIT.

V. No comment.

VI. Unrelated Debt Financed Income

The proposed change would reduce the flexibility that was the original purpose of section 514(c)(9), the ability of the organizations to act prudently would be hampered, and certain exempt organizations would be forced to deal with additional complexity in the tax law with no apparent commensurate benefit. While the purpose of the proposed change appears to be to restrain real estate investments by the qualified entities under section 514(c)(9), it could have the effect of forcing smaller qualified entities out of real estate investments entirely. It could also make these entities the only participants having amounts at risk in certain transactions.

With the prudent man rule for pensions in place, this additional burden should not be necessary for pension trusts and, in fact, may conflict with the duties placed upon fiduciaries by other code sections. For educational and section 501(c)(25) entities, the change may have the opposite of the intended effect. By investing more in fewer projects, the results of real estate investment failures may have a greater effect than under current law.

The proposed change will also cause additional complexity for the organizations. The 20 percent equity provision would most probably be required to be maintained over the term of the investment. The organizations would need to monitor distributions to be assured that the 20 percent level was not violated.

VII. Subsidiaries and Joint Ventures

A. Modify the definition of "control" in the case of exempt organizations having taxable subsidiaries.

It is reasonable to revise Section 512(b)(13) and its definition of "control" under Section 368(c) to restrict the opportunities for abuse under current law. Changing the definition of control to ownership of at least 50 percent of stock by vote or value, however, is too inclusive. The provision would have an impact on joint venture situations where each party holds a 50 percent interest, with neither party having actual control. Defining control of ownership of more than 50 percent is preferable because it would encompass only those situations in which there is an opportunity to manipulate the rent or royalty arrangement. With a more than 50 percent test, exempt parent organizations would still have to sacrifice voting control in order to avoid the application of section 512(b)(13).

The provision would be more consistent with other anti-abuse provisions of the Internal Revenue Code if it defines control as ownership of more than 50 percent of vote or value. For example, section 957 of the Subpart F provisions defines a controlled foreign corporation as "any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of the stock of such corporation is owned ... by the U.S. shareholders...."

B. Extend "control" rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock.

This proposal should be rejected. It is difficult to understand exactly what abuse this proposal is intended to redress. Perhaps the subcommittee believes it is possible for a group of unrelated exempt organizations to structure a series of rent, royalty, and loan arrangements that approximates their ownership share. For example, three unrelated exempt entities could each own one third of a taxable entity. One exempt organization could loan funds to the taxable entity and receive interest that would be deductible to the taxable entity and tax free to the exempt lender. The second exempt organization could rent facilities to the taxable entity on the same basis, and the third could license an intangible asset. Although it is theoretically possible that the interest, rents, and royalties received by each exempt organization would be proportional to their one-third interests, it is extremely unlikely in the real world. Particularly over a period of time, the amounts received by each entity would vary. The exempt entity receiving interest income at a fixed, arm's length rate is unlikely to agree to an excessive royalty arrangement with an unrelated exempt organization because this would directly reduce that entity's economic benefits from its one-third share interest. The only real issue here is the arm's length nature of the arrangement, not the fact that the exempt entity is not taxed on the receipt of the income item.

Perhaps, the Subcommittee perceives some harm in universities combining resources to transform advances in research into commercially viable products. The following example illustrating the operation of the provision suggests this type of concern:

> If X university owns 30 percent, Y university owns 30 percent, and Z university owns 30 percent of a for-profit organization that manufactures a pacemaker, that organization is treated as a controlled subsidiary of each of the universities.

The proposed provision is contrary to the U.S. public policy goal of promoting the rapid commercial development of new technology. It would cause a conflict between national economic policy and the Internal Revenue Code for no apparent reason. In order to reduce the current trade deficit, we should be encouraging technological advances. A recent article in Forbes states that more than 400 firms in Massachusetts alone, with revenues last year of $27 billion, have been founded by alumni or professors of MIT based on technology discovered in the school's laboratories. During 1987, MIT collected $3.1 million in royalties, which sustains and enhances the university's research programs. This activity should be encouraged so that the United States can retain its lead in high technology. If several universities combine their efforts to produce a technological breakthrough, that effort should be encouraged rather than taxing the royalties to the exempt organizations.

Perhaps the Subcommittee is concerned that the income from these ventures will be used for purposes which would not advance the national policy. For example, there may be concern that a new football stadium would be built with the royalty income, rather than investment in additional research. If so, then the use of royalties should be restricted to additional research-related expenditures.

C. Provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization.

The difficulties with the provision are twofold. First, the purpose of placing a nontaxable activity in a taxable subsidiary may not be tax avoidance. Identification of UBI activities is not easy. The area can be so gray that entities may not know what is or is not a UBI activity. There is a danger that this provision would be interpreted to equate any money-losing activities with not-for-profit activities, which would not be UBI to the exempt parent.

In addition, there may be valid business reasons for placing exempt activities in taxable subsidiaries. For example, the activity may be the exempt organization's contribution to a joint venture. Without that contribution, the co-owner may be unwilling to enter into the venture. The owners of the subsidiary may also be contemplating taking the subsidiary public

Second, administration of this provision could prove very difficult. As mentioned above, identification of the UBI in a taxable subsidiary may be difficult. Furthermore, the provision leaves open many questions that would have to be addressed. For example, where the subsidiary is co-owned by an exempt and a taxable organization, would the provision disallow only that portion of the loss attributable to the tax-exempt partner's ownership percentage? Would that disallowed loss, then, be treated as a carryforward so that if the company eventually went public, the other shareholders would have the benefit of the previously disallowed loss? Is the converse of the provision also true: if the exempt organization chooses to conduct an activity through a taxable subsidiary, that would be nontaxable if performed by the organization itself, would the income be exempt from tax?

D. Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of parent is a tax-exempt purpose.

It should be made clear that the aggregation of subsidiaries includes both for profit and not-for-profit subsidiaries.

If aggregation rules are adopted, it will be necessary to determine those activities which are in furtherance of an "aggregated" organization's tax exempt purpose and the criteria which will be applied for establishing the primary, as opposed to other, purposes of the activities of the organization. One such criterion might be the percentage of income from unrelated vs. related activities. Case law has carved out an uncertain range from 15 percent to 50 percent for allowable income from unrelated business activities. Aggregating subsidiaries with the parent corporation would probably place many exempt organizations within that range, creating the potential for an abundance of litigation. The purpose for establishing the taxable subsidiaries in the first place was to protect the exempt status of the parent organizations. If there was doubt regarding the character of income from a planned activity, the exempt organization might set up a subsidiary to carry on that activity in order to protect the parent's exempt status. The provision would create uncertainty because exempt organizations would be unable to determine whether their exempt status is in jeopardy.

The provision would also discriminate against smaller institutions that hold taxable subsidiaries. Because their gross receipts are lower, it is more likely that owning a taxable subsidiary would jeopardize the parent's exempt status. As James J. McGovern points out in his article "The Use of Taxable Subsidiary Corporations by Public Charities--A Tax Policy Issue for 1988," Tax Notes, March 7, 1988, "hospitals will be able to aggregate a significant amount of subsidiary business activity without failing a 'primary purpose' test." The provision would operate as a license for large organizations to expand into commercial areas; whereas, smaller institutions would be forced to divest themselves of their holdings.

VIII. Allocation Rules

Denying an allocation of overhead and depreciation to exempt organizations any denying a deduction for the excess of readership costs over circulation income to such organizations does not place them on a level playing field with non-exempt organizations. Rather, it discriminates against them. A fairer, albeit more complicated, course would be to prescribe allocation rules to prevent abusive over-allocations of exempt function expense to unrelated business income.

IX. Tax Information Reporting/Internal Revenue Service (IRS) Administration

All reconcilable items should be accompanied by an explanation as to why such income is tax exempt income. In addition, there should be a required statement describing the nature of the income that the organization is generating.

It is also important to address the expense side of the equation. Even if all of the taxable income is reported, no tax will be paid if overhead expenses are inappropriately apportioned to taxable income, thereby offsetting that income. Organizations should, therefore, be required to attach a summary of overhead expenses and a statement demonstrating how the allocation factor used to apportion the overhead was calculated.

Rental income should also be separately addressed. Presently rental income is excluded from unrelated business tax income, but generally to the extent it is debt financed the rental income is taxable (with certain exceptions). More questions should be asked concerning debt financed property, which highlights this taxable, tax exempt distinction.

The Form 990-T should be filed with either the 990-PF or the 990. This would serve as a reminder to organizations that the unrelated business tax must be addressed annually.

The proposed follow-up study should be undertaken after three, not five years because of the nature and depth of the proposed changes.

X. Miscellaneous

There are several proposed changes under this category. The following comments are responses to the topics indicated.

Social Clubs

The Subcommittee proposes to codify the position taken in Rev. Rul. 81-69, 1981-1 C.B. 351, and not allow losses from sales of food and beverage to be offset against investment income.

Congressional intent must be clarified if this proposal is intended to solve the present conflict. Section 512, as presently constituted, defines unrelated business taxable income as all income of a social club except for exempt function income. It does not specifically define unrelated business income as only investment income. Rev. Rul. 81-69, *supra*, prohibits an offset, because the activities with non-members are presumed not to be engaged in for profit. Many of these organizations do attempt to profit from their non-member activities. A codification of Rev. Rul. 81-69, *supra*, would suggest that it is Congress' intent to treat non-member activities of social clubs as not-engaged in for-profit and subject to UBIT. If this is the case, it would seem that the original legislation would have defined unrelated business income as net investment income.

If such a position is now deemed to be Congressional intent, it still leaves open the question as how to deal with clubs that generate a profit from non-member activities, or profits in some years and losses in others.

An integrated event concept should be adopted (See *North Ridge Country Club vs. Commissioner*, 89 T.C. No. 49 (9/15/87). This would treat these various taxable activities of exempt organizations in a manner similar to that of regular corporations, which aggregate various activities in determining taxable income.

Contingent Rental Income

Section 512(b)(3) excepts rents from unrelated business in certain circumstances. Section 512(b)(3)(B)(ii) states that rents are not excepted from unrelated business income if the determination of the amount of such rent depends in whole or part on the income or profits derived by any person from the property leased other than an amount based on a fixed percentage or percentages of receipts or sales. The proposed change in the law would allow an exempt organization to have contingent rents with a primary tenant if that tenant followed certain procedures which track the requirements that the exempt organizations must follow under section 512(b)(3)(B)(ii). This change would allow the tax exempt organization more flexibility in its rental arrangements while preserving the current restrictions. This change is a reasonable expansion of the law.

Modification of Piecemeal UBIT Exclusions

Low Cost Article Exclusion

How would the organization value the articles to determine the portion of the amount receivable allocable to the sale of the item and the portion properly classified as a charitable contribution?

Should the fundraising nondeductibility disclosure provision be coordinated with the Subcommittee's previous discussions regarding fundraising nondeductibility disclosures by section 501(c)(3) organizations (See Rev. Rul 67-246, 1967-2 C.B. 104, and Rev. Rul 86-63, 1986-1 C.B. 88)?

Income From Federally Regulated Activities

What other federally regulated activities besides radio broadcasting are considered within the scope of the fundraising nondeductibility provision?

What is "certain income?" Does it simply encompass income from the commercial aspects of an activity or all the purely religious aspects? Existing law taxes advertising income received for support of broadcasting that is primarily motivated by commercial purposes. (See Rev. Rul. 55-676, 1955-2 C.B. 266, and Iowa State University of Science and Technology vs. U.S., 500 F.2d 508 (Ct. Cl. 1974). Would this provision extend UBIT to broadcasting and other activities primarily motivated by educational purposes such as providing a training laboratory for students? Would it extend UBIT to charitable contributions received by televangelists from on-the-air solicitations?

* * *

The AICPA welcomes the opportunity to work with members of the Committee to further develop the above discussion options.

COMMENTS OF THE AMERICAN LUNG ASSOCIATION
SUBMITTED BY JAMES A. SWOMLEY

The American Lung Association appreciates the opportunity to provide comment to the House Committee on Ways and Means, Subcommittee on Oversight regarding their recently released discussion options for Unrelated Business Income Tax. Before providing specific comments, background on the American Lung Association and its programs is provided to establish the context for the comments.

The American Lung Association is the nation's oldest voluntary health organization. Its mission is the prevention and control of all lung diseases. This mission is carried out through programs in research and training, education of both the public and the health care professional, and public advocacy. Since its founding in 1904 as the organization dedicated to the attack on the major public health problem of that era--Tuberculosis, the American Lung Association has provided leadership in the development of rationale, scientific approaches to combat lung problems of potential catastrophic dimensions.

The American Lung Association is unique among the nation's voluntary health organizations. It is the only such agency with a medical section that is also a recognized medical specialty organization. The Society's 9000 members include physicians, scientists and other highly qualified health professionals. Major activity, in addition to functions as the American Lung Association's medical advisory body, include an internationally recognized annual scientific meeting and the publication of the world's premier journal on lung disease.

Lung diseases constitute a devastating and growing health problem in the United States. Lung diseases range from the chronic and often fatal diseases of the newborn, to serious infectious diseases, to those related to environmental exposure--workplace and ambient air, and to diseases attributable to cigarette smoking--the leading cause of preventable disease in the United States today. An emerging area of concern is the AIDS epidemic--68 percent of all AIDS deaths are due to lung disease, generally opportunistic infections. In 1986, it was estimated that over 83 million Americans, about one-third of the United States population, had chronic respiratory disease, a category including seven conditions ranging in severity from chronic sinusitis to chronic bronchitis and emphysema. In the aggregate, lung diseases, inlcuding lung cancer, ranked third among the leading causes of death and were responsible for 12.5 percent of all deaths in 1984. Chronic Obstructive Pulmonary Disease and allied health conditions are the most rapidly increasing of the top ten leading causes of death between 1970 and 1984. The age adjusted death rate due to lung cancer and COPD increased 35 percent and 36 percent respectively.

Although the statistics present a grim picture, the American Lung Association's programs and collaborative efforts with government and the private sector have improved the nation's lung health outlook. A public health campaign was initiated in the early 1900's by the ALA--then the National Tuberculosis Association. The campaign sought to convince the public that transmission of Tuberculosis, then the nation's number one cause of death, could be prevented by individual and community action. Today, ALA is part of an effort to eliminate TB transmission in the United States by the year 2000. As the 1990's approach ALA has undertaken a major new program initiative, again looking at individual and community action and again going after the nation's current number one killer--smoking. The new program--A Smoke Free Family--builds on ALA's long term commitment to reduce smoking related morbidity and mortality first established in our campaign--"Kick the Habit" begun in the mid 1960's.

A major component of the American Lung Assocation's battle against lung disease is fought in the research laboratory. In addition to a strong research advocacy program which seeks to increase federal funds available for lung research, ALA conducts its own research program. More than 120 research grants were awarded in 1987. A major emphasis of the grant program is to assist young investigators in establishing research careers in lung disease. ALA's research program also recognizes scientists who have devoted their research careers to the causes and cures of lung disease. ALA currently supports 8 "Career Investigators"--a five year funding commitment to each awardee.

The programs of the American Lung Association happen because of public support.

ALA's major fund raising activity is the annual Christmas Seal Campaign, now entering its 81st year. The Christmas Seal Campaign is supplemented by a variety of so-called special events and corporate sponsorships. This fund raising activity is conducted soley for the support of the broad range of education and research activities related to achieving ALA's mission.

The American Lung Association understands the broad concerns the Subcommittee has with the Unrelated Business Income Tax and its intentions to develop recommendations to regulate further the activity of nonprofits which seek to raise tax free dollars through participation in business activity unrelated to their tax exempt purpose. ALA acknowledges the need for such action and believes such income should be taxed. For example, ALA, rightfully, continues to report, for purposes of the Unrelated Business Income Tax, the income generated from advertising in its medical journal, The American Review of Respiratory Disease. Our concerns with the Subcommittee discussion options relate to the expansion of Unrelated Business Income categories and the use of vague and ambiguous language to define these new areas of coverage. ALA believes that the Subcommittee should consider more effective application and enforcement of current authority to address the problems identified in its June 1987 hearings rather than the options for taxing now-exempt activity. In general, ALA opposes the repeal of the "substantially related" test which determines whether an activity that produces income for an organization is taxable. Further, ALA opposes the proposals to tax fund raising and program activity and the option regarding the taxation of passive income tax exempt organizations derive from royalties. These options, if enacted into law, would severely restrict ALA's fund raising activity with a corresponding impact on our ability to deliver programs to the public for the prevention and control of lung disease. Below are the American Lung Association's specific comments on the discussion options.

o Substantially Related Test

It is important to note at the outset that during the Subcommittee hearings the Internal Revenue Service and the Small Business Administration did not recommend the repeal of the "substantially related" test. The Small Business Administration did recommend, however, the further definition of "substantially related" activities. The American Lung Association recognizes application of this standard by the Internal Revenue Service has been broad and many organizations have further added to the situation by use of a liberal interpretation of the test.

The alternatives put forward in the Subcommittee's discussion options are vague and the distinctions unclear. The differences in assessing support for "substantial" versus "direct" is dependent upon their definition. Current law requires a strong connection between the activity and the exempt purposes of the organization for exemption. The current test also requires a "causal relationship" to the organization's charitable purpose and must "contribute importantly" to achieving those purposes. Without proper definition, it is unclear how a "direct" test would differ from the current "substantial" test. The American Lung Association views the option of determining whether each income producing activity standing alone is tax exempt in a similar framework. The option is not significantly different from current practice.

The American Lung Association has major objections to the third option within this category, that of retaining the current test of "substantially related" but including taxation of "specific inherently commercial" activity. No information is provided as guidance for determining how "inherently commercial" might be defined, rather a series of limitations is proposed. This option would result in major changes in many areas of activity and would significantly limit current exemptions--income producing activity for the nation's charities such as the American Lung Association. Such action would also impact other activity which provides direct support for major program initiatives. The American Lung Association's specific comments on the proposed limitations include:

Catalog and Other Mail or Phone Order Sales

No definition is provided to assess how this option might be implemented and which activity would be covered. The American Lung Association is concerned

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that several of its program support activities might fall into this category of coverage without careful consideration of an appropriate definition.

For example, the American Lung Association maintains a "Supply Service" which has as its primary purpose the sale and distribution of a range of program education and fund raising materials produced by the ALA, and services to its 134 local and state offices. The "Supply Service" operation is offered to our local and state offices for the convenience of the economies of bulk purchasing. Without knowing how this test would be applied, ALA is concerned that the income derived from the service now utilized to upgrade and expand the service would become taxable income rather than income available for support of the program activity.

Medical Equipment, Laboratory Testing and Pharmaceuticals
No definition is provided to assess how extensively this option would be applied. Again, the American Lung Association is concerned that inappropriate application may severely impact its current programming initiatives.

For example, the ALA's medical section, the American Thoracic Society, manages a program to provide standardized testing for laboratories engaged in arterial blood gas analysis. The program is provided to enable laboratories to develop and maintain high standards for the conduct and interpretation of such tests which are essential to the management of patients with severe lung diseases. It is unclear from the language provided by the Subcommittee whether the intent is to apply the tax to the test conducted by a laboratory or the testing of laboratories for quality control purposes.

Travel Services
This provision would tax certain tour and related activity. Again without clear language as to the application of the proposal, it is difficult to assess the impact upon activity of the American Lung Association. A concern we would have relates to a special fund raising event--the "Trek" program. This program provides the opportunity for individuals to make charitable contributions to the American Lung Assocition while engaging in a variety of outdoor activities. This summer for example, ALA will sponsor the second annual TransAmerica Bike Trek, a biking tour across the United States in which the riders secure pledges of support for miles ridden. ALA is concerned that a broad interpretion of travel services would severely impact a significant source of income which is derived from charitable gifts. Of further concern are options under consideration that would consider income derived from the pledges as fees subject to taxation--clearly individuals pledging support during such an event do so as a charitable gift.

Affinity Credit Cards and Catalog Endorsements
The definitions and scope of this option are critical in terms of its application. It is quite proper, in ALA's opinion, to tax charities when they compete with a commerical activity. The use of affinity credit cards, catalog sales and other corporate promotions can achieve success only because a donor chooses to do something beneficial for a chosen charity and therefore, should not be treated as Unrelated Business Income for tax purposes. Without a conscious action on the part of an individual there would be no income to the charity.

Advertising
Advertising is currently taxed only if the publication earns an overall profit. The proposal would subject all income from advertising to the Unrelated Business Income Tax and only direct costs of advertising would be deductible. The American Lung Association currently reports, for the purposes of the Unrelated Business Income Tax, on its journal, The American Review of Respiratory Disease. However, further changes in the application of Unrelated Business Income Tax to advertising could have a significant impact in other program support areas such as activity related to announcing the organization's annual scientific meetings. Without proper definition of commerical advertising, it is unclear how broadly such a proposal would be applied.

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o Regularly Carried On Test

Among activities currently exempt by the "regularly carried on" test are a variety of fund raising activities. Further, income from advertising related to conventions is generally exempt under this test.

The American Lung Association is especially interested in this option. An annual black tie event is held annually to generate funds for the support of the organization's research program. Because, in general, only modest activity is needed to meet the trade or business requirement, the standard would be met by most income producing activity. ALA would encourage the Subcommittee to continue exemptions for galas and similar events since they do not constitute a business activity.

Royalty Exclusion

Under current law all income that is legally classified a royalty is exempt from the Unrelated Business Income Tax. The Subcommittee proposes to deny the exemption to royalties based on the net income. The American Lung Association believes that broad application of the proposal could be potentially expensive to it. ALA has developed royalty income based on the use of its name and good will. This is strictly an effort to use the support that individuals want to give to charity for specific program activity. It appears inappropriate to put a tax on a charity's good name and good works.

The Subcommittee proposes to continue exemptions for "certain nonworking property interests". The scope of the concept of "property created" by an exempt organization is not adequately defined and therefore, the unclear language again makes this proposal difficult to assess.

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ASHA American Speech-Language-Hearing Association
10801 Rockville Pike • Rockville, Maryland 20852 • (301) 897-5700 (Voice or TTY)

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

May 19, 1988

RE: UBIT Application
to University
Hearing Aid Sales

Dear Mr. Leonard,

The American Speech-Language-Hearing Association (ASHA) has been pleased to participate in the Subcommittee on Oversight investigation into the unrelated buisness income tax. In addition to the points raised in our previous comments, ASHA would like to stress the need for clarification of the options as they would apply to the sales of hearing aids by university programs in communication sciences and disorders.

The universities we are concerned about are those institutions of higher education which prepare students at the master's degree level for careers in audiology. Many of these universities operate a speech and hearing clinic to incorporate into the training of audiologists part of the 300 clock hours of required clinical parcticum experience with clients with communication disorders. (See attached ASHA Guidelines for Graduate Training in Amplification.) Usually these clinics provide services by students at reduced fees, which is appropriate since the students are not fully qualified professionals.

"Real life" experiences in the dispensing of hearing aids and related devices is extremely valuable for training audiology students. Today, the technology of hearing aids and other devices is changing as never before. As can be seen from the attached article, Hearing Instrument Dispensing in University Clinics by Robert H. Margolis, Ph.D., those training programs which directly dispense to clients do believe that their structure meets the goals of the training program whereas those who refer to external dispensers of conclude that that structure does not meet their training goals.

The options paper of the Subcommittee reveals, in many other areas, an appropriate sensitivity to the legitimate requirements of universities to properly train students. For example, UBIT would not apply to bookstore sales of "articles in furtherance of educational programs" (option I.A.). UBIT would not apply to health and fitness activities if "available to a reasonable cross-section of the general public" (option I.C.). UBIT would not apply to travel and tour services conducted by "colleges and universities to students and faculty as part of a degree program cirriculum and de minimis sales to not-students/faculty", (option I.D.). UBIT would not apply to adjunct food sales provided primarily to faculty and students (option I.E.) UBIT would not apply to a hotel facility operated by a university as part of its cirriculum in hotel management but only to the extent that such income is dervied form services provided by such faculty and students necessary for the university cirriculum purposes" (example discussed under option I.G.). UBIT would not apply to laboratory testing which is part of a student education training program (option I.H).

ASHA believes that the Committee should be equally sensitive to the legitimate needs of audiologists in training. We would suggest that, in the section dealing with the application of UBIT to the sale or rental of medical equipment and devices, language be inserted which would state that the UBIT would not apply to institutions of higher education engaged in the dispensing of hearing aids as part of an education program for audiologists to the extent of the income is derived from the services of faculty and students. We thank you for your attention to this very important aspect.

Sincerely,

Morgan D

Morgan Downey, Director
Governmental & Legal Affairs
Department

Attachments

Guidelines for Graduate Training in Amplification

The following guidelines were developed by the Committee on Amplification for the Hearing Impaired and adopted by the ASHA Legislative Council in November, 1983. Current and past members of the Committee responsible for the development of the Guidelines include Angela Loevenbruck, past Chair; Larry Marston, current Chair; Elnora Baiser, Ruth Ann Bentler, Evelyn Cherow, ex officio; Beverly Goldstein, Herbert Greenberg, Dennis Hampton, David Hawkins, H. Patricia Heffernan, Roger Kasten, Jack Kile, Sharon Lesner and Vice Presidents for Clinical Affairs, Hughlett Morris and David Yoder.

Prerequisite Areas

Persons providing professional audiologic services in amplification should demonstrate knowledge of the following prerequisite areas through academic content and practical application:

I. General science areas including acoustics, anatomy and physiology of the speech and hearing mechanism, basic electronics, instrumentation, and calibration.

II. Pathology of the auditory system, including disorders of the peripheral and central auditory system, and treatment modes for auditory disorders.

III. Speech and language development, including normal development, and speech-language deficiencies associated with congenital and acquired hearing loss.

IV. Audiological evaluation procedures including complete pure tone, speech, acoustic immittance, electrophysiological measures and site of lesion tests; and case management, counseling, referral procedures, and report writing.

V. General audiologic rehabilitative procedures, including determination of rehabilitative needs, interviewing and counseling, in-service training strategies, and long-term remediation strategies for individuals regardless of age or degree of hearing impairment.

Specific Competency Areas in Amplification

These areas are directly related to amplification and are suggested for inclusion in a model curriculum for graduate level courses in amplification. They are considered the minimum to provide an adequate base of knowledge in amplification. Persons providing audiologic services in amplification should demonstrate knowledge of:

I. Physical and electroacoustic characteristics of hearing aids and other assistive amplification devices including:
   A. Physical characteristics of hearing aids including types, components, batteries, volume and tone controls, and limiting networks;
   B. Current and previous national and international terminology and specification standards;
   C. Measurement methods for electroacoustic characteristics in compliance with existing or proposed ANSI standards;
   D. Other electroacoustic measurement procedures; such as, probe microphones and manikin systems;
   E. Effects of acoustic and electroacoustic modification on real-ear gain.

II. Earmolds (materials, types, tubing and impression techniques, modifications) and earmold acoustics.

III. Room acoustics, including the effects of noise, reverberation and distance on speech intelligibility, and environmental modifications to improve room acoustics.

IV. Principles and methods of evaluation, including:
   A. Need for selection of characteristics for amplification using case history, self-assessment, audiological assessment data, and effects of acoustic and electroacoustic modification on user experience with hearing aids;
   B. Selection procedures and protocols, such as traditional comparative evaluation, prescriptive fittings, and master hearing aids;
   C. Rationale for selection of various hearing aid characteristics and types of fittings, such as style of aid, monaural and binaural, CROS variations, directional microphones, and compression;
   D. Procedural modifications for special populations, such as pediatric, geriatric, and developmentally and physically disabled.

V. Rehabilitative procedures including:
   A. The hearing aid orientation process;
   B. Counseling with and on behalf of hearing-impaired individuals about hearing aids, hearing loss and its effects on speech and language development;
   C. Assessment and rehabilitation techniques for remaining communication problems of the hearing aid user;
   D. Rehabilitative procedures appropriate for special populations.

VI. Procedures and equipment for maintenance, troubleshooting, and making minor repairs.

VII. Personal and group auditory trainers, including types of systems, rationale for use and evaluation procedures for selection and monitoring of these systems.

VIII. Hearing aid delivery systems (including development and changes in these systems), equipment and facilities for dispensing, state and federal legislation and regulations pertaining to the manufacture and sale of hearing aids and related equipment.

The Committee believes strongly that, in addition to the prerequisite and specific competency areas stated above, the training of audiologists should include preparation for employment in settings in which dispensing hearing aids is part of the services provided. Therefore, audiology students should be acquainted with the business and marketing aspects of hearing aid dispensing.

A REPORT

Hearing instrument dispensing in university clinics

By Robert H. Margolis, PhD

Since the revision of the Code of Ethics of the American Speech-Language-Hearing Assn. (ASHA) in 1978[1] pertaining to the sale of products by audiologists and speech-language pathologists, hearing instrument dispensing has been rapidly incorporated into the clinical practices of audiologists. Professional attitudes toward dispensing as part of the management of hearing-impaired clients appears to have changed dramatically over the last 20 years. Where the sale of hearing instruments was once widely considered to be engaging in profit-making activities that somehow compromised the professional stature of the audiologist, it now is considered to be a legitimate, even necessary, component of the comprehensive clinical practice.

Those attitudinal changes are reflected in the rapidly increasing number of clinicians who dispense hearing instruments, reflected in several recent surveys. The 1984 ASHA Membership Update Survey indicated that 36% of ASHA-certified audiologists were dispensing hearing instruments, a substantial jump from the pre-1979 level, which was essentially zero. A survey based on 230 respondents to a questionnaire sent to 750 randomly-selected audiologists in 1983 indicated that 47% were dispensing hearing instruments.[4] The results of an ASHA survey sent to audiologists in 1985 in preparation for Federal Trade Commission hearings indicated that 63.5% were dispensing hearing instruments. The 1985 ASHA Membership Update Survey indicated that 41% of employed, certified audiologists dispense hearing aids.[2] Taken together, these surveys reflect a rapidly-changing posture of clinical audiologists regarding hearing instrument dispensing, perhaps the most dramatic change in the profession since its inception.

A change of this magnitude raises a question regarding the training of clinicians involved in hearing instrument dispensing. Where do clinical audiologists obtain the training in the various areas necessary to conduct a hearing instrument dispensing service? In order to obtain data on this question, and to help in our effort to build a case for dispensing at the Syracuse University Gebbie Speech and Hearing Clinic, in September, 1985, a brief questionnaire was sent to the 163 audiology training programs listed in the 1984 Directory of the Council of Graduate Programs in Communication Sciences and Disorders. By February 1986, 49 responses were received; a second mailing went out to the non-responding programs. The combined results presented below are based on a total of 125 completed questionnaires, a 77% response rate.

Respondents were asked to identify the hearing instrument delivery system they employed from the following list:

1. None
2. Referral to hearing instrument specialist
3. Mail order[3]
4. Dispensing (sale directly from clinic to client)
5. Other (describe)

In addition, the questionnaire included the following questions:

Are you contemplating a change in your hearing instrument delivery program? If yes, explain.

Have you had legal problems associated with your hearing instrument delivery program? If yes, explain.

Have you had economic difficulties associated with your hearing instrument delivery program? If yes, explain.

Does your hearing instrument program meet the educational objectives of your training program?

Respondents were asked to comment on any problems or benefits of their hearing instrument delivery program that their colleagues should know about.

Results and discussion

The distribution of delivery systems employed by the responding programs is shown in Fig. 1. A number of programs indicated that they refer to dispensing audiologists, so that delivery system was added to the analysis of results. The largest number of programs refer their clients to hearing instrument specialists, the "traditional" delivery system employed by all university clinics before 1979. Approximately equal numbers of programs employ the mail order and direct dispensing models. The mail order system[3] provides many of the characteristics of direct dispensing, while eliminating the business aspects of selling hearing instruments (including profit). Direct dispensing, employed by 20% of the programs, appears to be employed by university clinics at a much lower rate than by audiologists as a whole. The large number of programs that have no hearing instrument program or refer to hearing instrument specialists or dispensing audiologists suggests that the majority of audiology training programs have not

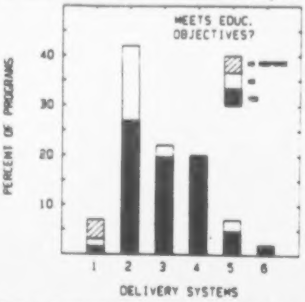

Fig. 1. Percentage of audiology training programs (N = 125) employing each of six hearing instrument delivery systems: 1 = None; 2 = Referral to Hearing Instrument Specialist; 3 = Mail Order; 4 = Dispensing; 5 = Referral to Dispensing Audiologist; 6 = Other. Within each bar the responses to the question, "Does your hearing instrument delivery program meet the educational goals of your training program?" are indicated.

Robert H. Margolis is with the Communication Sciences and Disorders Program at Syracuse U, Syracuse, NY

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changed their approach to hearing instrument delivery since the 1978 change in the ASHA Code of Ethics.

Two programs indicated that they employ "other" delivery mechanisms. One allows a faculty member to dispense privately from the university. Another orders the hearing instruments from a local dispenser (a "drop shipment"), apparently a variant of the mail order model.

Also indicated in Fig. 1 is the proportion of programs in each category that indicated that their hearing instrument program meets, or does not meet, their educational objectives. These data should be interpreted with caution as respondents may be reluctant to suggest, even anonymously, that their clinical procedures do not meet the objectives of their training program. Of the nine programs that have no hearing instrument delivery program, two indicated that their "program" meets their educational objectives, two felt that it did not and, interestingly, five did not respond to the question.

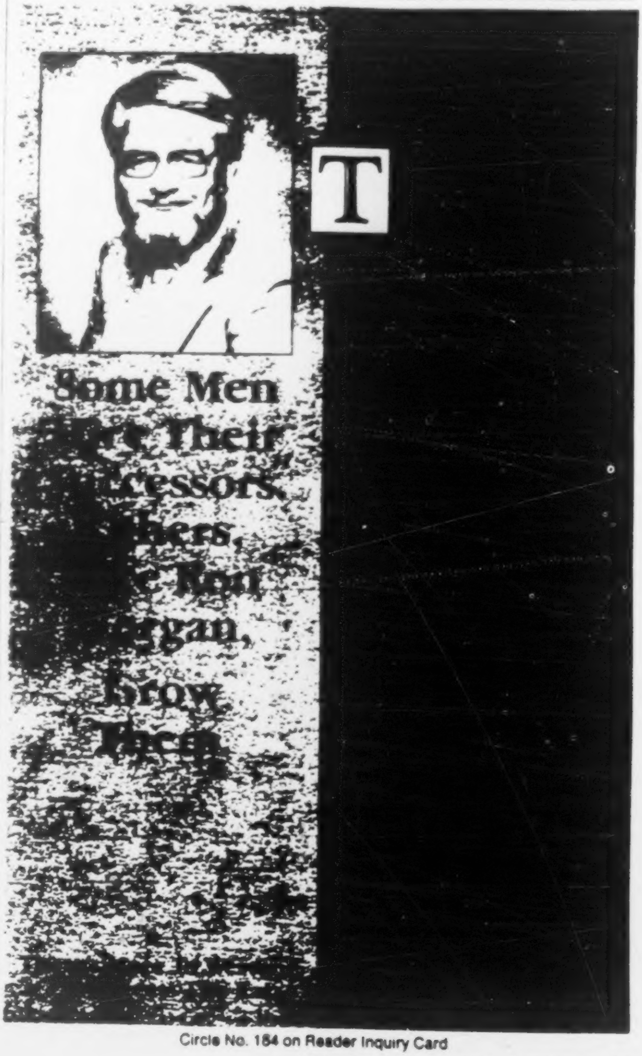
The highest proportion of dissatisfaction was associated with the hearing instrument delivery mechanism most frequently employed, referral to hearing instrument specialists. Of this group, 36% indicated that their program did not meet their educational objectives. Approximately the same proportion (33%) of those referring to dispensing audiologists indicated dissatisfaction.

The mail order and direct dispensing models were associated with high levels of satisfaction, 89% and 100%, respectively. These programs provide continuity of care to the client and offer the student the opportunity to participate in the entire hearing instrument delivery process. The lack of exposure to the business aspects of hearing instrument dispensing apparently was not reported to be a major educational shortcoming by 89% of those who employ the mail order program.

Another indication that many programs are dissatisfied with their current hearing instrument program is in the number that are contemplating a change to another system. Of 27 (22%) that indicated that they are contemplating a change, 26 are considering direct dispensing, while one is considering the mail order model. Interestingly, 12 of those who are contemplating a change indicated that their current program meets their educational objectives. Although the change may be motivated by non-educational considerations, several comments suggested that experience in the business aspects of hearing instrument dispensing is a desirable educational objective.

The results of this survey suggest that university programs are slowly following the lead of practicing clinicians in incorporating hearing instrument dispensing into their clinical programs. The relatively low proportion of training programs that provide experience in dispensing is certainly, and at least partually, attributable to legal, financial and administrative difficulties encountered by university programs that try to sell products, even for educational purposes. Since university audiology programs are frequently cited for their criticism of profit-motivated hearing instrument sales programs,[3] it would seem incumbent upon training programs to establish models of hearing instrument delivery that strike the proper balance between the realities of keeping a business afloat and the interests of the hearing-impaired client. The challenge facing the university audiology clinic is to provide a clinical service that includes the sale of hearing instruments "as part of a program of comprehensive habilitative care,"[1] while producing the revenue required to support the program. At this juncture, the universities cannot claim leadership in this area. These training programs are faced with a decision regarding the training of clinicians in hearing aid dispensing. Either they must provide training in all aspects of clinical audiology or rely on outside agencies to provide certain components of the training of their students. Main-

Continued on page 67



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COMPUTER from page 18

accounting firms have computer consultants on their staffs. All cities have computer consulting services available. Ask colleagues in the area who are using computers if they are familiar with any of the computer consulting services. The advice of the consultant may result in the selection of a less expensive and/or more efficient system, thus saving money in the long run.

8. **Give careful consideration to the hardware system.** When considering various hardware systems, simple considerations such as repair or service availability, place of purchase or simply knowing someone who has a computer can help in the decision-making process. Some of the factors to consider in choosing hardware are speed of operations, storage capacity, terminal capacity and the ability to add further storage and function to the computer.

9. **Make back-up copies of computer records.** At least weekly, make an extra set of diskettes with all the records stored in the computer. Then, if something happens resulting in a loss of the data, an additional copy exists to recreate the original data.

This has been an overview of how a personal computer can be utilized in a hearing instrument dispensing office. Properly used, along with the proper software, such a system can improve operational efficiency of the office, decrease overhead and, most importantly, increase profits. ☐

Address further inquiries to Michael C Pollack, PhD, Professional Hearing Services Inc, 157 W Cedar St, Suite B-12, Akron, OH 44307

CHALLENGE from page 50

Custom Hearing Instruments? In an article in the June 1956 issue of THE HEARING DEALER (HEARING INSTRUMENTS' former name), entitled "Teamwork Means Efficiency," Hagedorn was described as a good executive who utilized efficient business management techniques to build his sales volume to record levels. Today, the use of exclusive and efficient business and marketing procedures developed for the marketplace of the '80s are again enabling Custom Hearing Instruments to maintain a leadership position in hearing instrument marketing, particularly in the area of individuals who have never used hearing instruments before. ☐

A REPORT from page 39

taining quality of training, while relying on others to provide clinical experience for students, has been difficult to achieve. Hearing instrument dispensing by the university clinic may be the best way to provide both quality and comprehensiveness of clinical training in an area that is becoming central to clinical audiology. ☐

References

1. American Speech-Language-Hearing Assn (ASHA): Code of Ethics of the American Speech and Hearing Assn. ASHA 21(1):25-26, 1979
2. Cherow E: The practice of audiology: A national perspective. ASHA 28(9):31-38, 1986
3. Hawkins DB, Shepard NT, Benner RA and Davis JM: An alternative to direct hearing aid dispensing for university training programs. ASHA 24(6):435-438, 1981
4. Martin FN and Sides DG: Survey of current audiometric practices. ASHA 27(2):29-36, 1985
5. McCollum HF: What was, what is and what may be. Hear J 39(7):18-21, 1986

Address further inquiries to Robert H Margolis, PhD, Syracuse U, School of Education, Div of Special Education and Rehabilitation, 805 S Crouse Ave, Syracuse, NY 13244-2280

MAKING THE MOST from page 12

and write them into the appointment book.

It is important to establish a specific time period to accomplish certain tasks. By allocating "everyday at 4:00 p.m., every Friday at 9:00 a.m., each January ...," a routine can be established which allows time for achieving specific goals.

For example, increased leisure time can be realized by appropriate planning. While the cost of any vacation to a small business owner includes the cost of lost business, it can be minimized by utilizing the slow business periods for vacation time.

Evaluation

Every program needs a method for gauging its success. At the beginning and end of each day, re-evaluate the "to do" list. Check off those tasks completed and reassess those remaining into new A, B, C categories. Periodically, each staff member should ask themselves if they are making the best use of their time at that particular moment. Everyone should examine their actual time usage and determine if time spent on trivial activities could be avoided in the future. For example, a rule of thumb with paperwork is to handle each piece of paper only one time. When reviewing the mail, make decisions about the important and the unimportant and respond to, delegate or discard each item right then.

There should be a means for assessing the degree to which each activity contributes to the business' goals. For example, does the newsletter generate new business? How does it maintain contacts? Measurements can be as simple as counting the number of phone calls after each issue, determining which are new clients and which are former clients and how many of these became new sales. Any additional leisure time can be compared with the number of days or hours off in the previous years and compared against sales volume during that period. Such assessments make it possible to focus on the relative payoff of the activities performed and to determine if changes should be implemented.

Every person gets 24 hours a day, 168 hours a week. Therefore, it is not possible to get more time in a day. The techniques which have been outlined here, however, can help dispensers make more effective use of their time. ☐

Address further inquiries to Alice O Berkowitz, 39 Gramercy Park, New York, NY 10010

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The Art Insitute of Chicago
Michigan Avenue at Adams St.
Chicago, IL 60603
Telephone (312) 443-3600
May 9, 1988

STATEMENT

Re: Unrelated Business Income Tax Proposals Before
The House Ways and Means Subcommittee on Oversight

We are pleased to submit these comments for the written record of the May 9, 1988 hearings.

The tax exemptions Congress has granted us have been a major force in the life of our museum. The exemptions have made it possible for private gifts to create our art and architecture collections, libraries, and four year college of fine arts.

In return, Congress has rightly expected us to fulfill a public service mission. The purpose of these comments are to report to you what we have been doing with our tax exemption and how the proposals to change that exemption would affect us. We believe the effects on us are similar at many museums.

THE PROPOSALS

To us, no matter which proposal is selected, you will be establishing a new national policy. The policy will define what is public service and what is commercial enterprise.

We think all museums agree with Congress' objective of closing the door of government support for not-for-profits at the threshhold of commercial activities, while preserving support for their public services. We think its important to maintain tax equity with the taxable business community, while raising additional revenues where warranted. The proposals are well-intentioned.

But in proposing to re-draw the line between what is and what is not sufficiently related to be tax exempt, the "nature and scope" of related public service -- such as making available exhibition catalogues, books, reproductions, and lecture tours of art and architecture -- have been declared to be "inherently commercial" rather than a public service.

We think such a sweeping provision will have unintended consequences, and so must join with the American Association of Museums, the Smithsonian Institution, the Museum of Science and Industry, the Field Museum of Natural History, the Chicago Historical Society, and thousands of other museums here and around the country in opposing any change without further study, as recommended by the Treasury Department.

THE MUSEUMS' PUBLIC SERVICE

Understanding the museums' public service is vital to fair tax policy. It is, after all, half of what the "related" issue is all about.

We believe that the Subcommittee appreciates that the public service of museums is to build, conserve, study, and exhibit the collections they maintain for the purpose of preserving our culture and educating the general public. This public service is encouraged by Congress. It is highly unprofitable. We do not know of any for-profit museums, and this public service justifies our favored tax treatment.

Where we think the Subcommittee must penetrate more deeply is in the natural extension of the duty to exhibit and the duty to educate.

The Art Institute began 110 years ago with white plaster casts made from original sculpture and architectural fragments located in Europe. We did this to bring cultural education to the agricultural and industrial population of the Midwest.

Owing to our tax exemption, we received gifts to replace much of this in the ensuing 100 years with original art pieces from many periods and countries. This was an important step, providing the public a one-on-one experience with works of art.

We then took the next developmental step by making available reproductions of originals in our collections to impart knowledge to the public about our collections, and by publishing books and exhibition catalogues to place the art in context of the history, culture and movements of which our collections are only a small piece.

We are by charter and ethics committed to this public service mission of spreading knowledge to the general public about our collections and art related to our collections. We do not see our role as limited to that of a vault. Outreach programs are a vital part of what we do in meeting the cultural needs of a growing public.

EFFECT ON MUSEUM PUBLIC SERVICES

Some of the effects on our museum demonstrate where the proposals, in our opinion, inappropriately label our public services as commercial:

1. Exhibition catalogues.

(a) sold by museum shop and direct- mail.

We would be taxed where we make available to the public exhibition catalogues from other museums. We would be taxed on sales of exhibition catalogues from our own exhibitions where the method of sale is via direct mail. Yet we view these activities as a public service extension of the art and architecture libraries we maintain.

Exhibition catalogues document what is often a once in a lifetime assembly of art from around the world. Such exhibitions, often two to five years in the making, do not last more than a few months. We have a duty to make a record of the exhibition's cultural, aesthetic, and educational message, not only for those who saw the exhibition, but also for those who did not. It is our opinion that tax policy should permit us to make these catalogues available to the public tax free regardless of whether we were able to participate in the exhibition. Similarly any art museum should be able to make our exhibition catalogues available tax free to the public they serve.

(b) royalties from sales.

Often we license a commercial publisher to undertake distribution of an exhibition catalogue to be sold in book stores both in the U.S. and abroad. We often receive a royalty on these sales. Under the proposals, [illegible] royalties may be taxed because we created the [illegible] venture with private enterprise. But that is not the situation. Commercial publishers do not initiate or create exhibition catalogues, and they distribute only the most popular subjects. Thus many we do on our own. But when they are willing, commercial publishers can help us fulfill our public service role of making our exhibition catalogues available.

We believe royalty revenue from exhibition catalogues is a proper means of paying the costs necessary to render this valuable public service and should remain tax exempt.

(c) treatment of expense.

In 1987 we sold $2.6 million of exhibition catalogues and curatorial publications. An additional sting to the proposals is that many of the expenses attributable to producing the exhibition catalogues such as overhead would be denied under the proposed "allocation" rules. The justification for this is fine in concept -- to discourage the use of facilities for a commercial use, leaving them free for public service use. In practice, however, the proposals will discourage production of exhibition catalogues and will discourage creating a body of cultural knowledge and imparting that knowledge to the public.

2. Books.

(a) "general" books.

The proposals would tax our sales of "general" art books, such as a comprehensive text on art history, an artist's biography, and books on technique of drawing and painting. These help us to educate beyond our own collection. Museum collections are, in large measure, fragmentary and an accident of fate, consisting of a part of an artist's work, a part of an historical art period or art movement, a part of a national or cultural history. The books provide a way for the public to fit these pieces into their larger context of historical and cultural development.

(b) sales via direct mail.

Curatorial publications which we have authored and published about our collection would be taxed when sold via direct mail. We have made available to Congressman Pickle our brochure "Books 1986" for a list of our books to demonstrate that the publications are without question educational. Direct mail is a critical tool by which we reach people from here and around the world. It lets people locally and from around the world know what we have and helps to better educate the public we serve.

Where we can, we provide free publications to visitors. Examples are:

H. C. Westerman, Selections from the the Alan and Dorothy Press Collection;
Renaissance Decorative Arts from Chicago Collections;
Robert Ryman: The Charter Series;
Foreign Visitors' Guide to The Art Institute of Chicago;
Francesco Clemente: The Argentario Paintings.

But this requires a great deal of money. The volume of books and publications sold is increased by sales through our museum shop and through direct mail. This volume is not commercial. It is necessary to fund the cost of doing the book in the first place. The start-up fixed costs often exceed $150,000, and depend on volume savings in printing costs to keep the book in a price range of under $20 rather than in excess of

$50, a cost barrier to our public service. Even then, our volume printed is below what a commercial publisher would consider, and the prices higher than what we would like.

3. Reproductions.

(a) sales by Museum Shop.

The proposals would tax museum shop sales of cards, posters and other items that depict art that is owned by other museums, even where the artist is represented in our collection. We believe the public we serve should not be confined to our collection, because art and cultural artifacts are far too scarce and geographically dispersed. One cannot properly serve the public through any one museum's collection.

We feel we are doing our public service job when a person sees a postcard of an 18th Century European painting and then wants to see an original painting by that artist or a book about 18th Century art. Even if commercial business has entered this field through isolated selections, it does not do so in a way to connect in any meaningful manner to the subject of art or to a collection. We do, and provide a specialized public service. The selection is aesthetic and not commercial.

(b) sales by direct mail.

Our direct mail catalogue makes available items from our own collection and would be taxed. Yet the catalogue increases the public visits to the Art Institute galleries. Approximately 3 percent of the new members that we gain every year are a direct result of the public receiving direct mail catalogues and returning to the museum for a long overdue visit. The audience for this collection exceeds those who are geographically close by. This is a way we use to bring the experience of our collection to the public we serve, into their homes and into their lives.

(c) royalties on sales.

We license photographic transparencies of paintings to publishers of cards, posters and to manufacturers of adaptations. The transparencies are made from the original art, and are accompanied with a color code and white/black code to guide the accuracy of the reproduction process. We make available the original art in controlled circumstances for three dimensional reproductions.

We would be taxed on the royalties by dint of these services which assure that the public has a reasonably accurate version of the art depicted. This does not make us partners or joint venturers in a commercial enterprise, which apparently is the rationale for this proposal. We do not have the funds to reproduce that which should be done, so we license others to do this for us. We often buy some of these reproductions back for sale in our musem shop, making them available to the public to take home.

(d) momentos.

The proposals may tax the sale of some momentos that are not "low cost". But we ask that you consider the museum's intent, using one small example. We sell a museum tee shirt, which depicts our name and the signatures of many artists whose work is in our collections. This simple item tells the world we exist. Our staff has seen the tee shirt worn in Europe, Africa, Canada. It is our simple and quiet billboard traveling around the world inviting visitors to our museum [illegible] when staff encounters this tee shirt and asks about it, they find the person has either been to the museum or received it as a gift from a friend who visited the museum and recommended it. They remember it and are encouraged to visit. We do not think of this as commercialism. We ought to have the tax free right to notify the world we exist in the simplest of ways.

4. Tours.

The proposals would tax all of our educational tours. Our function as an arranger of an art and architecture tour is not to replace any commercial enterprise, and in fact we do not. Our function is to design and staff a cultural tour to provide an educational experience. Our museum staff (or a suitable substitute) leads these tours, providing instruction in the area of their specialities. We use commercial travel agencies, airlines etc. who want us to handle the billing and the organization of the tour and arrange the foreign sites to be visited. Many of the sites and collections are private and opened to the public on the tour only because we are a museum and have arranged the tour as an educational program.

We have made available to Congressman Pickle the brochure for our May 1988 tour of the art and architecture of Northern Italy. I believe you will agree this is an educational service. Many works of art do not travel because of personal, political and practical considerations which do not permit transport to the United States.

The tours allow the public to place our collection in context, and the public gains in appreciation of the art by visiting the people and country creating the art. Our museum and its collection come alive on these tours. Those who participate see a continuing fulfillment of their cultural needs. Over 25 percent become continuing donors to the Art Institute of Chicago and over 94 percent maintain their memberships.

Under the proposals, not only would all the revenue from tours be taxed, but the overhead costs would not be permitted as deductions, thereby generating an artificial surplus subject to tax.

EFFECT ON MUSEUM FUNDING

The costs of building, conserving, and exhibiting a collection are extensive. There are costs of professional staff, curators and art conservators, security, as well as facility maintainence and construction to preserve and exhibit the art. Our basic admission charge is currently very liberal, allowing the public to pay as they are inclined, and as they are able. We require a visitor to pay "something," suggesting $5 for adults, while admission is free to everyone one day each week and free to classroom tours. The cost of a visit, however, is over $16 per visitor, despite the fact that last year we hosted over 1.2 million visitors and were fortunate to have 68,000 hours of work contributed by 460 volunteers.

If each activity of the museum is to stand on its own, then the effect is that the admission charge would have to raised. We are concerned about creating a cost barrier to the general public. Our museum shop which sells cards and posters depicting art from our collection and other museums at a surplus helps to subsidize the cost of visitors to our galleries.

The effect of the proposals we believe will impact our admissions charge policy, and will make our collections less accessible to the poor, the elderly, those least able to pay.

Our activities last year resulted in a deficit of $178,000. It would have been much larger if we could not provide the services described in this letter in a tax exempt way. Our financial statements are audited and published each year together with a complete annual report of our activities. A copy of our last financial statements is enclosed. We are accountable to the Attorney General of Illinois.

We strongly urge that no change be made to the unrelated business income tax. The Treasury Department testified, we believe, that the wide variety of institutions to be affected required further study before specific tax code proposals could be made. We see the current proposals as disregarding this wise recommendation. With an act-now policy, Congress could do a great deal of damage to the art and cultural institutions that are fulfilling their responsibility of serving the public.

Sincerely,

Marshall Field

Condensed Statements of Revenues and Expenditures and Changes in Funds Balances

for the years ended June 30, 1987 and 1986

	Unrestricted Current Funds	Designated Facilities Renewal and Replacement Funds	Restricted Current Funds
Revenues:			
Educational and general:			
Endowment and investment income	$ 5,313,852	$ 916,397	$ 4,438,753
Museum admissions	1,821,890		
Tuition and fees	11,778,804		
Chicago Park District tax	5,350,225		
Gifts and grants:			
Annual Contributors Fund	3,600,434		
Student aid			3,909,904
Other	2,963,543		18,886,633
Annual membership dues	1,970,492		
Proceeds from sales of art objects			639,737
Proceeds from sales of curatorial publications			346,727
Exhibition catalogues and other	1,623,929		676,094
Total educational and general	34,423,169	916,397	28,897,848
Auxiliary activities	9,506,801		
Total Revenues	43,929,970	916,397	28,897,848
Expenditures:			
Educational and general:			
Curatorial and exhibitions	4,858,344		
Museum education and libraries	1,778,605		
Art object and book purchases			5,622,417
Curatoriel publications			337,393
General administration	5,941,084		913,245
Development, membership, and public affairs	2,926,049		227,599
Maintenance, security, and other plant expenditures	6,924,502		1,146,767
Plant and equipment improvements		1,241,941	13,164,753
Student instruction	5,384,502		249,141
Student services	1,725,765		
Student aid	1,449,048		5,189,555
Pension and other employee benefits (Note 2)	2,742,032		
Interest expense on notes payable (Note 3)	760,402	1,554,761	
Debt issuance expense		119,689	
Other	525,779		964,965
Total educational and general	35,016,112	2,916,391	27,815,835
Auxiliary activities	8,336,804		
Total Expenditures	43,352,916	2,916,391	27,815,835
Excess (Deficiency) of Revenues over Expenditures	577,054	(1,999,994)	1,082,013
Current funds designated	(1,630,194)	1,630,194	
Gains on sales of investments (Note 8)	875,104		660,455
Excess (Deficiency) of Revenues over Expenditures after Designation of Funds and Gains on Sales of Investments	(178,036)	(369,800)	1,742,468
Other Additions:			
Investment income	479,251		587,761
Bequests and other gifts	2,650,953		295,368
Fee for loan of art objects			
Proceeds from sales of art objects	197,500		
Plant and equipment improvements	78,002		
Other income	61,697		26,775
Total Other Additions	3,467,403		909,904
Other Deductions:			
Plant and equipment improvements			
Art object purchases	1,294,676		341,508
Total Other Deductions	1,294,676		341,508
Interfund Transfers – net	(2,158,517)	714,018	(343,015)
Balances, Beginning of Year	190,981	115,068	10,016,053
Balances, End of Year	$ 27,155	$ 459,286	$ 11,983,902

See Notes to Condensed Financial Statements.

1987		198				
Endowment Funds	Combined	Unrestricted Current Funds	Designated Facilities Renewal and Replacement Funds	Restricted Current Funds	Endowment Funds	Combine
	$ 10,669,002	$ 4,958,458	$ 2,347,991	$ 4,243,186		$ 11,549,63
	1,821,890	1,266,489				1,266,48
	11,778,804	9,837,470				9,837,47
	5,350,225	4,677,338				4,677,33
	3,600,434	3,323,423				3,323,42
	3,909,904			3,930,765		3,930,76
	21,850,176	2,867,599		8,750,487		11,618,08
	1,970,492	1,850,381				1,850,381
	639,737			1,474,544		1,474,544
	346,727					
	2,300,023	1,465,421	24,949	1,219,086		2,709,456
	64,237,414	30,246,579	2,372,940	19,618,068		52,237,587
	9,506,801	7,177,350				7,177,350
	73,744,215	37,423,929	2,372,940	19,618,068		59,414,937
	4,858,344	3,597,297				3,597,297
	1,778,605	1,655,857				1,655,857
	5,622,417			4,513,335		4,513,335
	337,393			149		149
	6,854,329	5,035,123		683,149		5,718,272
	3,153,648	2,436,174		572,641		3,008,815
	8,071,269	6,732,646		1,079,040		7,811,686
	14,406,694		1,342,703	7,002,172		8,344,875
	5,633,643	4,652,553		187,747		4,840,300
	1,725,765	1,536,594				1,536,594
	6,638,603	1,172,450		4,868,414		6,040,864
	2,742,032	2,158,324				2,158,324
	2,315,163	772,290	1,897,222			2,669,512
	119,689		328,481			328,481
	1,490,744	430,923		1,095,793		1,526,716
	65,748,338	30,180,231	3,568,406	20,002,440		53,751,077
	8,336,804	6,732,679				6,732,679
	74,083,142	36,912,910	3,568,406	20,002,440		60,483,756
	(340,927)	511,019	(1,195,466)	(384,372)		(1,068,819)
		(813,000)	813,000			
$ 15,834,188	17,369,747	336,099		305,828	$ 14,629,499	15,271,426
15,834,188	17,028,820	34,118	(382,466)	(78,544)	14,629,499	14,202,607
369,018	1,436,030	541,961		263,253	370,116	1,175,330
4,123,807	7,070,128	1,961,763		696,289	5,709,113	8,367,165
				300,000		300,000
	197,500					
	78,002					
	88,472					
4,492,825	8,870,132	2,503,724		1,259,542	6,079,229	9,842,495
		334,601				334,601
	1,636,184	217,420		122,831		340,251
	1,636,184	552,021		122,831		674,852
1,787,514		(1,937,492)	(141,817)	(884,062)	2,963,371	
115,510,305	125,832,407	142,652	639,351	9,841,948	91,838,206	102,462,157
$137,624,832	$150,095,173	$ 190,981	$ 115,068	$ 10,016,053	$115,510,305	$125,832,407

Assumptions used in accounting at June 30, 1987 and 1986 are:

Weighted-average discount rate	8.75%
Rate of increase in future compensation levels	6.5% to 8.1%
Expected long-term rate of return on assets	9.00%

3. Notes Payable

Notes payable at June 30, 1987 and 1986 consist of:

	1987		1986	
	Current Funds	Endowment Funds	Current Funds	Endowment Funds
Principal – Illinois Educational Facilities Authority:				
Adjustable Demand Revenue Bonds, Series 1985		$33,750,000		$34,000,000
Revenue Bonds, Series 1978	$110,000	12,640,000	$103,333	12,956,667
Unamortized discount and issuance expense		(294,273)		(308,484)
Total	$110,000	$46,095,727	$103,333	$46,648,183

The Adjustable Demand Revenue Bonds, Series 1985, payable in varying amounts and maturing on March 1, 2025, have adjustable methods of interest rate determination, demand features, and interest payment dates. At June 30, 1987, the issue is functioning in a mode set for a duration of six months ending August 13, 1987, and bearing a fixed interest rate of 4.05%. The Institute has agreed to maintain certain financial ratios related to debt service, including ratios of indebtedness to funds balances and assets available for debt service to debt service requirements.

The Revenue Bonds, Series 1978, payable serially from unrestricted endowment income through March 1, 2008, bear interest at rates ranging from 4.95% to 6.00%. The Institute has agreed not to invest endowment funds and funds designated as endowment in a manner which will result in unrestricted endowment income being insufficient to make principal and interest payments when due.

Minimum mandatory redemption payments, which approximate minimum sinking fund requirements, during the next five years are as follows:

Year Ending June 30,	Series 1985	Series 1978
1988	$250,000	$330,000
1989	250,000	345,000
1990	250,000	365,000
1991	250,000	385,000
1992	250,000	410,000

A substantial portion of the due to/due from other funds results from certain debt service related assets being included in the current funds whereas the related funds balances are included in the endowment funds.

4. Income Taxes

The Institute is a nonprofit organization exempt from income tax under Section 501(c)(3) of the Internal Revenue Code.

5. Interest of Trustees, Officers, Committee Members, Woman's Board Members, and Auxiliary Board Members in Transactions with The Art Institute of Chicago.

Trustees. The Institute maintains banking relationships with The First National Bank of Chicago, a wholly-owned subsidiary of First Chicago Corporation. Barry F. Sullivan is Chairman of the Boards of The First National Bank of Chicago and First Chicago Corporation and John H. Bryan, Jr., is a director. David P. Earle III is an officer of The First National Bank of Chicago. William Blair & Company, of which firm Bowen Blair is a senior partner, provides certain investment banking services to the Institute. Eckhart, McSwain, Silliman & Sears, of which firm William A. McSwain is a partner, serves as legal counsel and Skidmore, Owings and Merrill, of which firm Bruce J. Graham is a partner, provides architectural and engineering services to the Institute.

Officers, Committee Members, Woman's Board Members and Auxiliary Board Members. No Institute officers have a financial interest or association with a firm doing business with the Institute. Twenty-seven committee members, Woman's Board members, and Auxiliary Board members are associated with or are members of the immediate family of people associated with firms receiving fees for services rendered to the Institute.

Fees paid to any of the firms referred to above are commensurate to or less than fees normally charged by firms or individuals with comparable skill and experience in their respective fields. Under Institute policy, Trustees or committee members having a duality of interest shall abstain from voting on the establishment or continuation of relationships with their firm or employer. The Institute adhered to this policy in the years ended June 30, 1987 and 1986 without exception.

Also, the Institute has requested that its Trustees, officers, committee members, Woman's Board members, and Auxiliary Board members provide information as to their personal collecting activities and their use of Institute services, property and facilities. Their responses do not indicate any conflict between their interests and the policies, operation, or interests of the Institute.

There have been other relationships during the normal course of activity in the two years ended June 30, 1987 which terminated prior to this date and are, therefore, not reported above. None represented a conflict with the policies, operation, or interests of the Institute.

6. Capital Campaign

In October 1982, the Trustees unanimously resolved to undertake a capital funding program, The Campaign for Chicago's Masterpiece (the "Campaign"). The goal of the Campaign is to raise at least $51.5 million, with a minimum of $19.0 million for endowment and the remainder for construction and renovation of Institute facilities and Campaign related expenses.

The results of the Campaign fundraising efforts through June 30, 1987 are as follows (in millions):

Gifts	Cash Received	Pledges Outstanding	Total
Current restricted:			
Construction and renovation	$12.7	$ 8.0	$20.7
Unspecified	10.9	2.5	13.4
Total current restricted	23.6	10.5	34.1
Endowment	15.8	7.0	22.8
Total	$39.4	$17.5	$56.9

Included in Campaign results are gifts and pledges totaling $11.3 million and $1.2 million from the Chicago Park District and National Endowment for the Arts, respectively. The above results also exclude $4.3 mil-

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lion in gifts received or pledged in response to the Campaign but restricted for uses not included in the stated purposes of the Campaign. The amounts shown above also exclude the value of art objects and real property given or pledged in response to Campaign solicitations.

Expenditures made for purposes related to the Campaign, cumulatively totaling approximately $26.6 million through June 30, 1987, have exceeded related current restricted gifts received and accrued by $.6 million. Additionally, the Institute has entered into Campaign related construction contracts for which funds will be expended as work is performed. Approximately $5.9 million of such contracts are currently outstanding and are scheduled for completion prior to June 30, 1988. These amounts are expected to be funded upon the realization of the related pledges outstanding. To the extent that the pledges become uncollectible, other sources of funds will be made available as necessary. The interim cash flow requirements are being met through utilization of the proceeds from the Adjustable Demand Revenue Bonds, Series 1985 (Note 3).

7. Subsequent Event

On September 9, 1987, the Art Institute entered into a $5,000,000 real estate contract to purchase a building to be used primarily for School purposes. Closing on the contract is expected to occur approximately October 30, 1987. The total cost of the building, including expected equipment, furnishings, and renovation expenditures, is estimated to be approximately $16,500,000.

8. Investments

A substantial portion of the Institute's endowment and similar funds are combined for investment purposes. On July 1, 1981, the Institute revised its investment policies, diversified the investment management, and restructured its investment goals. In establishing these goals, the Trustees recognized their fiduciary responsibilities to (a) sustain the buying power of the endowments while (b) at the same time attain spendable income to realize the purposes of the endowments. In keeping with these responsibilities, the Trustees established an investment objective of (a) sustaining the buying power of the endowment principal by achieving a cumulative return (including market appreciation) equal to inflation, as measured by the annually weighted cumulative change in the average calendar year Gross National Product Price Deflator (26.69% for the six years ended December 31, 1986) plus (b) providing an additional return for spendable purposes (7.0% and 7.5% for the years ended June 30, 1987 and 1986, respectively) in the form of interest, dividends, and, to the extent appropriate, allocated realized capital gains.

A summary of the combined results against these goals follows:

	Spendable		To Sustain Principal
	1987	1986	July 1, 1981, through June 30, 1987
Investment results:			
Interest and dividends	$6,689,484	$6,291,331	
Realized and unrealized market appreciation	1,651,139	694,275	$47,507,026
Total results	8,340,623	6,985,606	47,507,026
Goals	8,340,623	6,985,606	23,394,370
Results over goals	Nil	Nil	$24,112,656

The annualized rate of total return on these combined investments, computed as the annualized sum of each week's total investment results divided by the sum of the beginning fair market value plus net additions to the funds, was 13.0% and 33.9% for the years ended June 30, 1987 and 1986, respectively.

Auditors' Opinion

To the Board of Trustees of The Art Institute of Chicago:

We have examined the condensed balance sheets of The Art Institute of Chicago as of June 30, 1987 and 1986 and the related condensed statements of revenues and expenditures and changes in funds balances for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying condensed financial statements summarize fairly the financial position of The Art Institute of Chicago at June 30, 1987 and 1986 and the results of its operations and changes in its funds balances for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins + Sells

Chicago, Illinois
September 30, 1987

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ASSOCIATION OF THE UNITED STATES ARMY

2425 WILSON BOULEVARD, ARLINGTON, VIRGINIA 22201-3385

(703) 841-4300

OFFICE OF THE
EXECUTIVE VICE PRESIDENT

May 23, 1988

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
Subcommittee on Oversight
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 25015

Re: Unrelated Business Income Tax

Dear Mr. Leonard:

I am writing to provide our Association's comments on proposals to modify application of UBIT contained in your press release of March 31, 1988. It is our understanding comments are being received through May 23, 1988.

This Association has been granted exemption from Federal income taxation under Section 501(c)(3) of the Internal Revenue code. It has a membership numbering about 155,000, which consists of US Army officers, enlisted men and women both in the active and reserve establishments, and other US citizens who have an interest in national defense matters.

In support of its educational mission the Association publishes a monthly professional journal and a newspaper, both of which contain advertising. To the best of my knowledge neither its magazine nor newspaper competes with any commercial publication.

I wish to focus on one critical issue -- discussion option J to impose a discriminatory and punitive tax on gross advertising margins of tax-exempt organizations. This is truly a revolutionary concept. The favorable comments by the Assistant Secretary of Treasury on this Option make it vitally important to bring the true nature of the proposal to the Committee's attention. It is not clear that the Secretary fully realized the implications of the Option.

First, I would like briefly to highlight the most inequitable aspects of the proposal:

1. It could result in the imposition of a gross income tax on enterprises conducted at a loss; and, in such cases, the tax would be paid out of income or capital related to the exempt function.

2. It is the only instance under the Internal Revenue Code where an income tax is imposed on only a portion of the revenue and expenses of an integrated enterprise.

3. It imposes a tax on revenues derived without allowance for all legitimate business expenses incurred to earn those revenues.

4. The UBIT, enacted in 1950 for the purpose of equalizing the taxation of competitive enterprises, is now being used for the purpose of knowingly and deliberately treating tax-exempt

organizations less favorably than their non-tax-exempt competitors operating under similar circumstances.

The issue is presented under a proposal to amend Section 512 that would treat advertising as a separate business, distinct and apart from the publication in which it appears and from which it derives its only value. Under the proposed amendment gross advertising margins would be subject to a tax imposed on net income even if the publication as a whole, after properly taking into account all items of income and deduction, incurs a loss. To simply state this proposition, is to refute it.

It hardly needs stating that advertising is not a separate and distinct activity from the publication in which it appears. Advertisers pay to reach readers and readers are generated by editorial content. The profitability of the advertising can only be judged in the context of the net cost of attracting the readers. Vast advertising profits could be generated if it were not for the mere detail of also producing a publication.

In his statement before the Subcommittee on Oversight, Assistant Secretary (Tax Policy) O. Donald Chapoton, recognized the inequity of the proposal but defended it as follows:

> "[1] This option reflects the view that the production of advertising income is of only secondary importance to the production of a tax-exempt journal. [2] As such, only direct costs of producing the advertising income are properly allocated to it. [3] We recognize that such an allocation rule treats tax-exempt journals differently, _and less favorably_, than taxable journals with respect to the computation of taxable advertising income. [4] Nonetheless, we believe tax-exempt journals are, in fact, fundamentally different from taxable journals and that Congress could appropriately adopt such a rule as one of the conditions of a journal enjoying the substantial benefits of tax-exemption."

The statement is remarkable for its presentation of four bald conclusions without any support. First, what basis is there for treating advertising as of secondary importance to a tax-exempt journal when, in most instances, advertising (as is the case with taxable journals) provides the essential financial prop for publishing the journal at all.

The second sentence stating that only direct costs are properly allocated to advertising income is simply a _non sequitur_ and even if advertising were of "secondary importance", that conclusion hardly justifies taxing income without allowing the deductions of all clearly associated costs.

Third, the Secretary appears to be saying that a journal which enjoys exemption of its taxable income should pay for that privilege by a tax on its gross advertising margins. But what are the "substantial benefits of tax exemption" where the publication operates at a loss? The rationale would appear to be that even though a journal loses money overall, the benefits of tax-exemption are so great, a journal should pay tax on an activity which is a mere component of a unitary business that enables it to lose less money!

Fourth, Secretary Chapoton frankly acknowledges, as he must, that this option does not provide a level playing field but operates to treat tax-exempt journals less favorably than taxable journals. If taxable publishers were also subjected to a gross margin tax, the results would be catastrophic but at least it would be fair -- competitors would be paying tax on the same basis. That was the only purpose of the UBIT when it was adopted in 1950 and remains so today. In fact current law does provide fair treatment of competitors by allowing all publishers to deduct the costs of publication. If non-profits were to publish their journals in taxable entities, their tax liabilities, calculating circulation income under Treasury Regulations, would be generally unaffected.

Under current law, Treasury Regulations Section 1.512(a)-1, provide a detailed formula for treating advertising income and expense in the computation of unrelated business taxable income. The following principles are well established:

1. First, there is no issue at all that advertising revenue is an unrelated business. This has been settled law since 1969.

2. In the event direct advertising income exceeds direct advertising cost, the "excess advertising income" (Regs. Section 1.512(a)-1(f)(2)(ii)) may be offset to the extent that costs of readership and production of a periodical exceed the circulation income of the periodical. If the tax-exempt periodical operates at a profit without advertising, then the excess advertising income is taxed in full. To the extent that the readership and production costs exceed circulation income, excess advertising income is reduced accordingly.

3. Circulation income is carefully defined by the regulations to include all amounts including allocable membership receipts "realized from or attributable to the sale or distribution of the content of the periodical". The complaint of taxable publishers, such as the Association of Business Publishers, in their testimony before this Committee is that tax-exempt publishers "artificially designate a low or no subscription price for all or part of its circulation". This is simply nonsense. The Treasury regulations rigidly prescribe the computation of circulation income. Where the journal is provided without further charge to each dues-paying member of a tax-exempt organization and in the absence of sufficient non-member subscriptions, the regulation mandates the portion of the dues which must be attributed to the subscription to the periodical. There is attached hereto as Exhibit A a sample computation of the determination of circulation income by a typical tax-exempt

organization. Circulation income includes actual subscriptions and single copy sales plus, in the case of membership receipts, that portion of the dues that the organization's publication expenses bears to its total expenses. This formula is written right into the Regulations adopted after extensive hearings and careful consideration. It is fair and it works. To the extent it needs fine-tuning to eliminate inequities in individual cases, this is an administrative matter and not the occasion for sledge hammer legislation as represented by discussion option J.

The basic complaint of taxable publishers, expressed in their testimony, is the artificial depression of circulation income and the resulting reduction of the tax on excess advertising revenue. The solution to this problem, if it is in fact a problem, is to encourage the Treasury Department to review its regulations to avoid abuses; or as a final alternative of legislation to insure that circulation income is properly computed.

In summary, the proposal is an anomaly. It is a punitive, deliberately one-sided proposal presented as an amendment to a provision of the Internal Revenue Code that is designed to insure fair competition. It might be well to recall the roots of this legislation in the Revenue Act of 1950. A report of the Senate Finance Committee stated the problem succinctly.

> "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition ... In neither the House bill nor your committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises nor require that they dispose of such businesses. Both provisions merely impose the _same_ tax on income derived from an unrelated trade or business as is borne by their competitors." (pp 28-29, S. Rept. No. 2375, 81st Cong., 2d Sess.)

Thirty-eight years later, this discussion option would do violence to the essential principal of the UBIT. It would deliberately treat tax-exempt organizations "less favorably" than taxable journals. It would reverse the burden of unfair competition and impose a punitive burden on tax-exempt publishers. They would not pay the same tax -- they would pay a higher tax. This should not be allowed to happen.

Sincerely,

/s/

ROBERT F. COCKLIN
Major General, AUS Ret.
Executive Vice President

May 20, 1988

Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1105 Longworth House Office Bldg.
Washington, D.C. 20515

Attn: Honorable J. J. Pickle, Chairman

Re: Comments Regarding the Adverse Effect on Churches of the "Discussion Options" for UBIT

Dear Mr. Chairman:

In the course of the May 9, 1988 Hearing on the Discussion Options for UBIT, none of the witnesses nor any member of your Subcommittee touched on the matter of whether certain provisions under prior law dealing specifically with churches would be appropriately adapted to preserve and carry over the prior law treatment of churches after adoption of any or all of the Discussion Options. The undersigned churches therefore advance the following comments and recommendations, in addition to comments filed independently by any one or more of the undersigned:

I. TAX INFORMATION REPORTING:

The undersigned object to the proposed expansions of the Form 990-T reporting requirements to include (1) activities and income which are excluded under UBIT and which have heretofore been non-reportable, and (2) revenue sources such as contributions, grants or other funding sources which are gifts and not income, particularly if the provisions affecting churches in Code §6033 are not correspondingly adapted to cover such an expansion. In the alternative, the foregoing kinds of information reporting would more appropriately be directed to the information return Form 990, which is already coordinated with §6033. The proposed expansions, if applicable to churches, would constitute a burdensome and inappropriate incursion by government into a most fundamentally sacred aspect of religious ministry. The principle of government non-interference into the internal workings of churches is essential to the vitality of religion in America, and is embodied in existing rules limiting the extent and conditions for tax reporting by churches. Those carefully crafted rules are working well to protect the free exercise of religion in our society, while providing adequate procedures for governmental review in cases of apparent abuse. The undersigned are opposed to amendments which would erode that protection.

II. TAXABLE SUBSIDIARIES:

There may be valid, important reasons, not inconsistent with religious and charitable purposes, for a Church to own certain taxable subsidiaries as part of its passive investment portfolio. Such subsidiaries are subject to tax consistent with their character, and their non-charitable purposes and operations have never been attributed to the shareholding church. The undersigned object to the present proposals to modify the tax rules governing their relations with such subsidiaries.

The proposed attribution of purposes and operations either from the subsidiaries to the charitable parent, or vice versa, would subject charities and their affiliates to tax rules more harsh than the rules that apply to other entities. The suggestion that ownership of such subsidiaries could jeopardize a charitable organization's exempt status as "exclusively organized and operated for charity" is particularly offensive, and disregards the substance, separateness and tax-paying status of the subsidiaries and the passive character of the charity's stock holdings. It could lead to forced divestiture which has no rational justification, other than to impose a disproportionate burden upon the associational rights of charities as compared to other organizations. To the extent that such a challenge to its exempt status could lead to forced disclosure of the charity's financial affairs, the impact on churches is especially objectionable.

Furthermore, the suggestion that affiliation with a charity creates unfair tax advantages, either for the charity or for the subsidiary, ignores the extensive laws and regulations already in place to prevent non-arm's length dealings between related parties. Because commercial affiliates of charities are fully taxable, file complete financial disclosures in connection with income tax returns on Form 1120, and are subjected to regular and extensive audits by the IRS, they already pay taxes on the same basis as non-affiliated taxable enterprises. None of the witnesses at the Hearing presented any evidence of actual tax advantages being realized through such affiliations. These proposals appear founded solely on speculation about hypothetical abuses. Therefore, the proposed changes would represent an unnecessary intrusion, not a cure for a real problem.

III. CONCLUSIONS:

The wording of the recent Discussion Options was vague enough to leave open the possibility that the changes proposed could have a substantial adverse impact on churches. There has been no testimony or other suggestion that such church-specific effects were intended. Therefore, in addition to careful drafting as suggested (1) to retain the protection for churches presently embodied in the relationship between the information return (Form 990) and §6033, and (2) to preserve the right of churches and other charities to own passive investments (including controlling interests), we strongly urge the establishment of a legislative record to aid the IRS in administering any changes to the law which Congress might enact to the effect that such changes are not intended to reverse the churches' protections under present law or to interfere with passive investments in separately operated taxable subsidiaries.

One of the principal reasons for the effectiveness of churches and other charities in contributing to the overall public good has been their freedom to be unique, independent and creative in defining and pursuing their charitable purposes. This has been the subject of long-standing Congressional encouragement in the structure of the tax laws. The undersigned object to the proposed changes discussed above which would undermine that well-established recognition of public benefit.

We invite your careful reconsideration of the above matters with a view to protecting and preserving the independence and vitality of religions and other charities in American society. The contribution of these institutions is immeasurable and must not be jeopardized by over-regulation.

Respectfully submitted by:

Babtist Joint Committee on Public Affairs

The Church of Jesus Christ of Latter-day Saints

General Conference of Seventh-day Adventists

National Association of Evangelicals

United States Catholic Conference

COALITION ON ROYALTIES

May 20, 1988

HAND DELIVERED

Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The Coalition on Royalties was formed by the below-signed organizations that are concerned about the Subcommittee's proposal to tax various types of royalty income. The Coalition on Royalties agrees with the questions raised at last week's Hearing by the nongovernment witnesses such as Independent Sector regarding the Discussion Option on royalties. This letter discusses two types of royalty arrangements used primarily as a fundraising mechanism that have not been fully addressed by these witnesses, namely affinity card programs and cause related marketing.

Affinity Credit Card Programs

In the typical affinity credit card arrangement, an exempt organization allows a financial institution to issue a credit card that is identified with the exempt institution. The name and/or logo of the exempt organization is prominently printed on the credit card and the promotional materials refer to the credit card program as one that is associated with the exempt organization. The affinity group and financial institution negotiate the terms of the credit card, e.g., annual fee and annual percentage rate, and the affinity group has the right to approve the promotional materials describing the credit card program that are prepared by the financial institution.

The exempt organization allows its name to be used on the promotional materials and may endorse the product, and the financial institution typically incurs substantially all of the promotional and mailing costs. The exempt organization permits the financial institution to use its mailing list of members or contributors for purposes of the promotion only, and the financial institution is prohibited from using the membership list for any other reason.

In exchange, the exempt organization receives specified amounts that depend on income generated from the program. Typically, the exempt organization receives a specified sum for each credit card that is issued. In addition, the exempt organization may receive a specified percentage of the total charges made by the card member and/or specified amount each time a member renews the credit card. Under this compensation arrangement, the financial institution makes no payments for its possession of the mailing list. Instead, it only pays the exempt organization upon the generation of income derived from the use of the exempt organization's name or logo on credit cards issued to members of the affinity group. In some affinity credit card arrangements, the financial institution pays a separate flat amount for the right to use the exempt organization's mailing list.

We are aware that some have questioned whether payments under an affinity card program represents mailing list rentals that may be taxable under current law. For example, Assistant Secretary Chapoton stated in his testimony to the Subcommittee on May 9 that "[t]o the extent income from credit card or catalog endorsements represents the rental of an exempt organization's mailing list, we believe it is already taxable under present law." Also, H.R. 3739 would subject affinity card arrangements to UBIT largely because of the sponsor's perception that affinity card royalties represent payments for mailing lists.

There are several points to be made regarding the mailing list issue as it relates to affinity credit cards. First, the predominant (if not exclusive) portion of payments received by an affinity group under an affinity card program represent compensation for the right to use the affinity group's name or a logo rather than for the right to use its mailing list. This allocation is supported by the typical compensation arrangement under which the financial institution makes royalty payments to the affinity group only to the extent that a credit card with the group's name or logo imprinted on it is issued or used. Thus, if an affinity group's membership does not respond to the financial institution's solicitation, the financial institution makes no payments to the affinity group. This is clearly contrasted with the typical mailing list rental under which the purchaser of the list makes a flat payment to the seller regardless of how the members respond to the purchaser's solicitation.

This compensation structure shows that the true value of an affinity credit card arrangement lies in the financial institution's right to use the name or logo of the affinity group on the credit card because of the close ties that an affinity member or supporter has with the group. Simply put, a financial institution pays an affinity group for the right to use its name or logo, not for the right to use the mailing list. The restriction that the financial institution cannot use the mailing list for any other purpose bears this out.

Second, access to an affinity group's mailing list is distinguished from the typical mailing list rental in that a financial institution may use the mailing list solely to solicit products that are clearly identified with the exempt organization. Unlike the typical mailing list rental under which the purchaser may use the list to solicit products of any sort, the financial institution in an affinity card program may use the list only to solicit interest in a program that fosters identification of the members with the affinity group in a program that the members know will raise additional funds for that group's exempt purpose.

Third, it is not clear how mailing list rentals are taxed under current law. Although the Tax Reform Act of 1986 specified that exchanges or rentals of mailing lists between two exempt organizations are not subject to UBIT under Code § 513(h)(1), the legislative history makes it clear that such change "carries no inference whatever that mailing list revenues beyond [Code § 513(h)(1)'s] scope or prior to its effective date should be considered taxable to an exempt organization." See 132 Cong. Rec. H 8361 (Sept. 25, 1986)(comments of Chairman Rostenkowski); 132 Cong. Rec. S 8244 (June 24, 1986)(colloquy between Senators Packwood and Pryor).

The only case that directly discusses mailing list rentals concerned an organization that the court found was actively engaged in the trade or business of renting and buying mailing lists. See Disabled American Veterans v. United States, 650 F.2d 1178 (Ct. Cl. 1981). In contrast, most affinity groups enter into only one or two credit card arrangements. Further, even this case noted that mailing list rentals could be properly excluded as royalties under Code § 512(b) if the exempt organization did not actively participate in the trade of business but merely received payments on a passive basis. Id. at 1189. Accord, Fraternal Order Of Police Illinois State Troopers Lodge No. 41 v. Commissioner, 87 T.C. 747, 757-58 (1986).

We note that Assistant Secretary Chapoton stated that current law imposes UBIT on a credit card arrangement only "to the extent" income from credit card endorsements represent the rental of an exempt organization's mailing list. This statement shows that even the Treasury Department is not convinced that an affinity card program necessarily entails a taxable mailing list component.

The other major criticism that has been levelled at affinity card arrangements is that they might represent the "exploitation" of an exempt organization's goodwill for commercial purposes. We believe that the better characterization of an affinity card program is the alternative offered by the Treasury Department, namely it is an activity designed to foster identification by members and supporters with the affinity group and to encourage contributions by such members and supporters.

As far as we know, no one has contended that affinity groups actively engage in a business or compete with taxable entities when they enter into an affinity card arrangement. No such contention would have merit, because it is the financial institution that issues credit cards, sends out billing statements, settles disputes, etc. The affinity group merely permits the financial institution to use its name or logo on the credit card in conjunction with the issuer's trade or business. Compare United States v. American Bar Endowment, 106 S.Ct. 2426 (1986). The only possible way to characterize an affinity card arrangement as a commercial transaction is if the program can be viewed as some sort of joint venture between the affinity group and the financial institution.

No such joint venture characterization is warranted. An affinity group bears no losses even if the program is unsuccessful. The affinity group provides no substantial services and incurs no substantial costs. The financial institution actively conducts the credit card business. The only involvement of the affinity group, again, is its permission to use its name or logo. This is not substantively different from an exempt organization's permission to a bank to use money that it deposits with the bank. An affinity card program certainly is no more of a commercial activity than rental of real property, in which an exempt organization may conduct leasing and servicing activities, yet no one questions the exemption of real estate rentals. In short, an affinity group is not involved in a commercial enterprise other than as a passive investor.

Moreover, the major reason why affinity cards have become increasingly successful over the last few years is that they are viewed as a way that members or supporters of an exempt organization may direct needed funding to the affinity group. The credit card market has become national in scope, and most credit-worthy people have little trouble obtaining credit cards tailored to their personal preferences, e.g. low annual fee or interest rate. Consumer organizations have noted that many affinity credit card programs offer terms that are less beneficial to the cardholder than regular credit cards. See 53 Consumer Reports 190 (March, 1988). Why then do so many members and supporters of affinity groups choose to participate in an affinity credit card program?

The only reasonable answer is that they are persuaded by the feature under which a portion of the proceeds from the program will be contributed by the financial institution to their affinity group. In substance, affinity card arrangements are not different from classic charitable fundraising activities under which contributors purchase tickets to an event for an amount in excess of the fair market value of the admission price. Some programs even include an automatic charge to the affinity group as a convenient way of contributing to the exempt organization.

Charges of exploitation simply do not apply to an arrangement under which royalties are paid exclusively for the right to use an exempt organization's name or logo, where the very reason payments are being made is the fact that members and contributors participate because of the name or logo rather than because of any particular attributes of the underlying product. An affinity credit card arrangement is different from the sale of catalogs offering materials wholly unrelated to the exempt organization but which has the name or logo of the affinity group printed on the cover of the catalog. In the latter case, charges of exploitation might exist, whereas in an affinity card arrangement the product being sold is marketed based upon its connection with the affinity group.

Importantly, affinity groups participate in affinity card programs not only to generate money directly from the programs but also to facilitate regular fundraising. Every time a cardholder uses an affinity credit card, he or she is reminded of his or her affiliation with the exempt organization. This constant reminder of the cardholder's affiliation with the exempt organization hopefully reinforces the cardholder's sense of identification with the affinity group and its exempt purposes. Such enhanced identification hopefully will lead the cardholder to be more generous during regular fundraising, because the cardholder will consider himself or herself a member of the affiliated group's "family" as a result of the repeated exposure to the group's name and logo.

Cause-Related Marketing

The Discussion Option relating to royalty income would tax royalties on a scope far broader than just affinity credit card programs. Many types of fundraising arrangements are in substance identical to affinity credit card transactions, and we believe any attempts to tax such arrangements would be inappropriate.

For example, many exempt organizations permit their names and/or logo to be used on merchandise (e.g., on boxes in which products are packaged) and receive payments based on the sales of such products. The business that makes such payments to the exempt organization widely advertises that a percentage of its sales will be contributed to the exempt organization. As with an affinity credit card program, the exempt organization does not take an active business role but instead merely permits a taxable business entity to use its name or logo in a passive manner.

Another variant of this fundraising mechanism is income from so-called "cause related marketing," in which a taxable business announces that it will contribute a specified sum of money to an exempt organization based on its sales during a given period. Once again, the exempt organization does not engage in a trade or business, but apparently would be taxed under the Discussion Option because it would receive payments for the right to use property it created, i.e., its name and/or logo. We note that affinity card programs could be restructured to a format under which the issuer pledges to contribute certain amounts to the affinity group based on each cardholder's use.

There is no apparent public policy for taxing such mechanisms for generating corporate charitable contributions. Over the past several years governmental funding of exempt organizations has steadily eroded. This decline of governmental support has placed pressure on exempt organizations to maximize its efforts to solicit support from the private sector. A corporation's generous offer to contribute funds to an exempt organization should not be diluted by treating such contributions as taxable royalties for that organization's express or implied endorsement of the corporation's products. Any such imposition of UBIT would severely retard the exempt sector's ability to solicit business contributions in the future.

We appreciate the opportunity to present our views and hope that this submission clarifies your understanding of affinity credit card programs and cause-related marketing. If you have any further questions, please contact any of the undersigned organizations or Tony M. Edwards, whose telephone number is (202) 887-1550.

Respectfully submitted,

Alliance of New York State Art Councils
American Association of Museums
American Association of Nurse Anesthetists
American Cancer Society
American Diabetes Association
American Kidney Fund
American Speech-Language-Hearing Association
Citizens Committee for the Right to Keep and Bear Arms
Council on Non-Profit Organizations
Cystic Fibrosis Foundation
Defenders of Wildlife
Foster Parents Plan
Juvenile Diabetes Foundation
International Wildlife Federation
Leukemia Society of America, Inc.
MasterCard International, Inc.
Mothers Against Drunk Driving
Muscular Dystrophy Association
National Alliance for the Mentally Ill
National Association of Childrens Hospitals
National Association of Public Television Stations
National Council of Jewish Women
National Guard Association of the United States
National Wildlife Federation
Navy League
Parents Without Partners
People for the American Way
Physicians for Social Responsibility
Sierra Club
Special Olymics
Vietnam Veterans of America
VISA U.S.A., Inc.

cc: Honorable O. Donaldson Chapoton

LEHRFELD & HENZKE, P. C.
A LAW CORPORATION
SUITE 403
1101 CONNECTICUT AVENUE, N. W.
WASHINGTON, D. C. 20036
(202) 659-4772

WILLIAM J. LEHRFELD
LEONARD J. HENZKE, JR.

April 18, 1988

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Leonard:

The undersigned represents several societies of scientists and engineers, the principal purpose of which is to provide continuing education to such professionals. We wish to comment briefly on Point D,(f) of the March 1988 "Description of House Ways and Means Oversight Committee Discussion Options for Changing the Unrelated Business Income Tax." Specifically, we are interested in the "Example" which states --

> (f) certain trade shows, state fairs, etc., including convention and trade show activities and public entertainment activities of a qualifying organization (Repealing provisions enacted in 1976 and expanded in 1984);
>
> Example:
> UBIT would apply to income of a business association for sponsoring, endorsing, and providing the support services of an international commercial trade show.

Over the years, the tax exempt status of convention trade shows of Section 501(c)(6) business leagues has been liberalized. Originally, the Service ruled that rental income earned at trade shows conducted by Section 501(c)(6) organizations would not be subject to unrelated business tax only if the organization vigorously enforced a no-selling and no-order taking rule. Rev. Rul. 75-516, 1975-2 C.B. 221.

In 1976, Congress added Section 513(d) to the Code, which the Internal Revenue Service interpreted to allow Section 501(c)(5) and Section 501(c)(6) organizations to hold conventions at which suppliers sold and took orders without paying unrelated business tax on the booth rentals.

In Section 1602 of the Tax Reform Act of 1986, Congress amended Section 513(d) so as to give equal treatment to booth rentals at conventions held by Section 501(c)(3) and (c)(4) organizations.

As a practical matter, the Service has always administratively allowed Section 501(c)(3) and (c)(4) organizations to hold conventions at which no sales or order taking took place, without paying unrelated business tax on booth rentals. That is the basic tax policy which Section 501(c)(3) and (c)(4) organizations have relied on over the past several decades. The 1986 provision allowing suppliers to make sales and take orders at Section 501(c)(3) and (c)(4) conventions was not necessary. The purpose of conventions held by Section 501(c)(3) and (c)(4) organizations is wholly educational, and they have no desire to dilute this purpose by authorizing supplier-exhibitors to sell products. Indeed, our clients do not even allow prices to be displayed.

On the other hand, the exhibition of products at conventions of Section 501(c)(3) organizations is an important part of the educational purpose of such meetings. Many Section 501(c)(3) organizations are scientific societies, where new developments in the field consist to a substantial degree in the new scientific instruments and other professional materials that have become available. New developments are explained in technical educational seminars, and are then demonstrated at the educational exhibition. Indeed, the term "trade show", implying commercial selling, is not used. Instead, the show is termed an educational exhibition. If booth rentals were declared to be an unrelated activity, many societies would have to substantially reduce such activities in order to ensure that their exempt status was not placed in jeopardy. Moreover, the tax on booth rentals would require increased convention fees and thus decrease the number of persons who could afford to attend such conventions.

In summary, we urge that booth rentals from Section 501(c)(3) conventions continue to be exempt from unrelated business tax, but would not object to a rule subjecting to unrelated business tax booth rentals at any conventions where selling or order taking took place.

Sincerely yours,

Leonard J. Henzke, Jr.

HERMANN

May 19, 1988

The Honorable J. J. Pickle
Chairman, Committee on Oversight
Committee on Ways and Means
1105 Longworth House Office Bldg.
Washington, D. C. 20515

Dear Congressman Pickle:

The Hermann Trust, on behalf of Hermann Hospital, appreciates this opportunity to submit comments on the Discussion Options Relating to Unrelated Business Income Tax (UBIT) for inclusion in the printed record for the May 9, 1988 hearing of the Subcommittee on Oversight, Committee on Ways and Means. The Hermann Trust is an exempt organization under Section 501(c)(3) of the Internal Revenue Code of 1986. The Hermann Trust owns and operates Hermann Hospital, a tertiary care hospital which is the primary teaching facility of the University of Texas Medical School at Houston. (UTMSH)

The Hermann Trust wishes to indicate its wholehearted support of the comments, submitted to the Subcommittee by the American Hospital Association and Association of American Medical Colleges, both dated April 15, 1988. Rather than repeat the analysis of those organizations, Hermann would like to provide the Subcommittee with examples of how the Discussion Options would affect the hospital's activities.

The Discussion Options propose repealing the "substantially related" test or modifying it with a "inherently commercial activity" test and eliminating the "convenience" exception. Two years ago, the Internal Revenue Service performed a UBIT audit of the Hermann Trust. At that time, various activities were examined to determine whether they were unrelated functions, it was determined that they were not. Any change in the tests would place the Hermann Trust in an ambiguous situation. We are currently operating under well-defined IRS advice and precedents which provide Hermann with administrative guidelines for our patient care and support activities. The changes proposed in the "substantially related" test represent drastic or undefined departures from current law which would have the undesirable negative effects of uncertainty and unfairness.

The Hermann Trust

Texas Medical Center
6410 Fannin
Houston, Texas 77030-3003
713-797-1600

For example Hermann Hospital, like other hospitals, has used the definition of "patient" defined in Rev. Ruling 68-376, 1968-2C.B. 246, to guide its delivery of diagnostic and therapeutic services. Many patients are referred to Hermann's outpatient services for laboratory, radiological, cardiac, pulmonary, and other testing. In fact, many of these services have been developed in response to the federal government's mandate through the Medicare program to redirect service delivery from the inpatient to the outpatient setting. Our outpatient services are also the result of medical research activities, some which have been funded by the federal government. Such outpatient services are vital to cost effective treatment and continuity of care. The definition of "patient" should continue to encompass all individuals who receive health care services for which the hospital is responsible, both inpatients and outpatients.

The Discussion Options advocate applying UBIT to routine testing other then testing provided for hospital patients, federal or state mandated activities, and lab testing which is part of a student's educational training program. Hermann can support this proposal as long as the definition of "patient" in Rev. Rul. 68-376 continues to apply. Hermann supports the exception for lab testing which is part of an academic/clinical training program for medical students and lab technicians. Hermann Hospital performs all the laboratory testing for two hospitals which do not have laboratories. The lab-test orders received from those hospitals are vital to our teaching program.

Hermann Hospital provides an array of services to two hospitals, Shriner's Crippled Children's Hospital and the Harris County Psychiatric Center. The Shriners' Hospital is located on the Hermann campus and is physically connected by a tunnel. This crippled children's hospital receives food services, utilities, engineering, laboratory testing, pharmacy, cardiology/pulmonary care and business office services from Hermann. Hermann provides these services to Shriner's because the facility lacks the size and capability to provide these support services and specialized care within its facility. These services are provided at cost or at deep discounts. Thus, Hermann's provision of services enhances Shriner's ability to provide the highest quality of care to the crippled children. The current IRS position is that under these circumstances, Hermann is directly involved in the promotion of an individual's health, regardless of whose patient he or she is. Such services are obviously "substantially related" to our charitable mission. Thus, Hermann strongly recommends that the Section 513(e) exemption from UBIT be retained, and that adjunct food sales in this circumstance also be exempt from UBIT.

Hermann Hospital also provides an array of services to the Harris County Psychiatric Center (HCPC). This is a state/county-owned facility which is operated by the UTMSH. The medical staff of Hermann's psychiatric department is the same as the medical staff of the HCPC. Hermann provides this psychiatric hospital with pharmacy, laboratory, cardiology, radiology and pastoral care services at cost or substantial discounts. The HCPC lacks the capacity to provide such services. Again, Hermann should not be taxed on those activities which promote an individual's health, are substantially related to our charitable mission and are essential to the teaching program of Hermann Hospital.

Congressman Pickle, as you can see, the generalized changes to UBIT suggested in the Discussion Options would result in taxation of Hermann Trust for activities which we developed in response to changing health care needs or because the services were essential to the operation of two closely-related facilities.

The Hermann Trust advocates that current UBIT tax law be retained so that Hermann can respond with flexibility to our patients and our related institutions. Thank you for the opportunity to respond with our views.

Sincerely,

E. Don Walker

E. Don Walker
President
The Hermann Trust

js

Juvenile Diabetes Foundation International
432 Park Avenue South New York New York 10016-8013 212-889-7575 Telex (RCA) 238 790 NYKUR FAX 212-725-7259
EXECUTIVE OFFICE

STATEMENT OF
JOAN BEAUBAIRE, PRESIDENT,
JUVENILE DIABETES FOUNDATION INTERNATIONAL

for the record of the hearing conducted by the
Subcommittee on Oversight
of the House Ways and Means Committee
on the Unrelated Business Income Tax
on May 9, 1988

The Juvenile Diabetes Foundation International (JDF) is an international voluntary health organization devoted to furthering research into the causes and treatment of diabetes and to improving the quality of life for diabetics. It has over 160 local chapters and affiliates in the United States and throughout the world. JDF is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code. Over the last twelve years, JDF has raised over $45 million for its charitable projects. All of those funds have come from private fundraising activities.

As JDF's ability to pursue its charitable mission is directly linked to its ability to raise funds, JDF has followed closely the Subcommittee's examination of the Unrelated Business Income Tax (UBIT). JDF salutes the Subcommittee for its careful approach to UBIT reform and its willingness to listen to concerned members of both the for-profit and the not-for-profit communities. JDF appreciates this opportunity to submit comments for the record of the Subcommittee's May 9, 1988 hearing. These comments are submitted in an effort to describe for the Subcommittee the effects that certain "discussion options" currently before the Subcommittee would have on JDF and on other similarly-situated tax-exempt organizations.

Of the various discussion options presented by the Subcommittee, three would have the greatest impact on JDF and its affiliated organizations: (1) the proposal to modify the current exemption for passive income by taxing royalties paid to an exempt organization in exchange for use of the organization's name or logo; (2) the proposal to deny tax-exempt organizations the right to offset normal overhead and administrative expenses against taxable advertising income; and (3) the proposal to tax specifically those royalties paid to exempt organizations in connection with affinity group credit cards. JDF urges the Subcommittee not to include these options in its legislative proposal.

1. Royalty Income

JDF is engaged in several fundraising projects in which a taxable entity has been authorized to use the JDF name and logo in exchange for royalty payments. These projects raise a significant amount of funds for JDF, and their share of JDF revenue is expected to rise over the next several years.

The royalties JDF receives through these projects are currently exempt from UBIT. One of the discussion options put forward by the Subcommittee would eliminate this exemption. JDF opposes this change. Its greatest concern is, of course, financial: licensing of its name and logo is one of the most effective avenues the organization now has available for raising funds, and subjecting such revenues to tax would reduce significantly the dollars available for JDF's charitable activities.

JDF does not contend that its income from these programs should be exempt from tax solely because the funds generated are ultimately directed to charitable purposes. Rather, JDF believes that there are additional sound public policy reasons for exempting such royalty income from UBIT. First, these projects are an important part of the organization's educational mission and a complement to its direct solicitations from the public. Licensing taxable enterprises to use the JDF name and logo in various promotional activities helps to increase public awareness of JDF itself, the extent and effects of diabetes, and the need for charitable giving to support diabetes research.

Second, to tax income earned by exempt organizations through licensing of their names and logos would be a significant departure from current tax policy, which generally exempts all "passive" income of charitable organizations. This policy has proved a logical and functional distinction, and should not be changed lightly.

Third, and most important, there is no evidence that the current exemption for royalty income has permitted exempt organizations to compete unfairly with for-profit businesses. In none of the testimony presented at the May 9 hearing was it suggested that for-profit businesses have had their own royalty income reduced as a result of the exemption for exempt organizations' royalty income. JDF's exemption has not enabled its licensees to offer their products at a lower price than is charged by licensees of non-exempt organizations. In the absence of some evidence that the current exemption has given an unfair advantage to exempt organizations, JDF sees no policy justification for changing current law.

2. Advertising Income

Like many tax-exempt organizations, JDF publishes a journal for its members and donors. The JDF journal appears quarterly and typically contains articles discussing JDF activities, advances in diabetes research, new approaches in diabetes management, products of interest to diabetics and their families, and similar topics. In addition, the journal contains paid advertisements for products and services of particular interest to diabetics. Because diabetics and their family members constitute a high percentage of the journal's readership, JDF is able to successfully sell advertising space in the journal to the manufacturers of diabetes-related products.

Under current law, exempt organizations -- like all sponsors of publications -- are permitted to offset expenses related to publication of the journal against their advertising revenues. The Subcommittee's discussion option, however, would permit exempt organizations to offset against their advertising income only those expenses that are directly attributable to the advertising. Expenses attributable to the editorial portions of the magazine could not be offset. Exempt organizations such as JDF that publish journals containing advertising would thus be subjected to heavier taxation on their advertising income than would non-exempt publishers.

JDF believes that adoption of this discussion option would be unwise. First, the income that JDF earns from such advertising subsidizes the journal's educational articles. Increasing the effective rate of taxation on advertising revenues would limit JDF's ability to publish a high-quality journal.

Second, subjecting advertising income earned by exempt organizations to harsher rules than are applied to advertising income earned by publications sponsored by for-profit publications is bad tax policy. The purpose of the Unrelated Business Income Tax has always been to "level the playing field" between exempt and non-exempt organizations when exempt organizations enter areas of business that are unrelated to their charitable purpose. Current UBIT rules have established such a "level playing field" in this area. UBIT should not be used to place exempt organizations at a disadvantage.

Finally, at least in the case of journals that, like JDF's, are read primarily by the very persons the sponsoring organization is dedicated to assisting, it is inappropriate to view the solicitation and publication of advertising materials as a commercial venture. The advertising portion of JDF's journal contributes importantly to the educational purpose of the organization as a whole. Just as several articles in each issue of JDF's journal present information of practical use to diabetics and their families, the journal's advertisements also serve to inform the journal's readers of products and services that can assist in the management and treatment of diabetes. These considerations argue strongly against subjecting JDF's advertising revenue to tax at all -- and certainly against subjecting such revenue to higher effective tax rates than are applied to the advertising revenues of non-exempt publishers.

3. Affinity Cards

JDF now sponsors a relatively small affinity card program, and hopes that the program will grow over the next several years. JDF urges the Subcommittee not to subject to UBIT the royalties that it receives from its affinity card program.

JDF believes that there is no reasonable policy justification for distinguishing affinity card programs from other types of "passive" or royalty income. Indeed, in many respects such programs are more closely tied to the organization's exempt purpose than are other clearly-exempt licensing and royalty arrangements. The presence of the JDF name and logo on a credit card reminds the user of the organization and promotes identification with the organization.

More important, tax-exempt organizations' sponsorship of of affinity cards does not constitute "unfair competition" with taxable entities. No taxable organization which sponsors an affinity card has shown that its royalty levels have been suppressed because of the sponsorship of similar programs by exempt entities, or that exempt sponsors have been using their tax exemption to undercut the programs of non-exempt entities.

Summary

In today's environment, charitable organizations such as JDF must also seek new sources of funding if they are to continue their charitable missions. JDF is currently providing more than $12 million per year to support diabetes research -- supplementing, and to some degree replacing, federal funding. It makes no sense for the federal government to look to the private sector to support medical research and similar charitable activities while, at the same time, the government erects roadblocks in the path of charitable organizations' fundraising activities.

Specifically, JDF believes that passive royalty income should remain exempt. Second, tax-exempt entities should continue to be permitted to offset their publishing expenses against their advertising revenues, as there can be no justification for subjecting tax-exempt publishers to harsher rules than are applied to taxable organizations. Finally, JDF urges the Subcommittee to reject the proposal to tax income from affinity card programs.

3360e

michigan vma

May 12, 1988

Chairman J. J. Pickle
Subcommittee on Oversight
House Committee on Ways and Means
U. S. House of Representatives
242 Cannon H. O. B.
Washington, DC 20515

Dear Congressman Pickle:

The Michigan Veterinary Medical Association, a 1200 member organization representing the veterinarians of Michigan, responds to the request from the Subcommittee to comment on the options regarding unrelated business income tax (UBIT) on non-profit organizations. These comments pertain to veterinary services provided to the general public by tax-exempt organizations such as humane societies. Your Subcommittee has recommended applying unrelated business income tax to select veterinary services provided by these non-profits.

Regarding the options your subcommittee has recommended, the "substantially related test" states that UBIT should be applied to certain veterinary services such as grooming, boarding and elective surgery, excluding all others as they are either directly related to animal health or to public health. Grooming and boarding are not veterinary services and therefore unnecessary to consider. As for elective surgery, the majority is spaying and neutering, which you have excluded. With nearly 100% of actual veterinary services excluded from UBIT, this recommendation will do absolutely nothing to alter the status or activities of a non-profit. If you are going to recommend enforcing the UBIT, it should be on all veterinary services provided to the general public.

However, we must point out that, in our opinion, stricter enforcement of UBIT will do nothing to solve the problem of unfair competition between tax-exempt, charitable non-profits and taxpaying for-profit small businesses. The monies required to pay the tax would only be taken from those funds designated for charitable purposes and do nothing to prevent unfair competition. The promotional advantages of non-profits may represent their greatest asset in business competition, even though their clinics are built with tax-exempt contributions.

What the MVMA suggests is for your committee to recommend that all veterinary practices, that are involved in the sale of veterinary services to the general public, excluding those involved as teaching hospitals, be required to operate as separate "for profit" entities. Veterinary practices limiting their services to stray animals or those owned by indigents, or to spaying and neutering procedures could still be exempted from UBIT with no additional financial liability.

Michigan Veterinary Medical Association
1405 South Harrison Road, Suite 307
East Lansing, MI 48823
(517) 332-2913

Peter A. Prescott, D.V.M.
Executive Director

If your subcommittee recommends to continue to allow veterinary services for the general public to be provided by tax-exempt charities, with or without UBIT, there is an alternative to provide for fairer competition. If these services are among the charitable purposes of these organizations, then recommend to the IRS that these same services, when provided by a tax-paying for-profit business, be considered a charitable contribution for the taxpaying pet owner, deductible on their federal tax return under charitable contributions? This would help neutralize the financial advantages the non-profit receives without penalizing them through additional taxation. In addition, animals would benefit as their owners would be more likely to seek veterinary care if it were tax deductible. The for-profit business would continue to pay taxes as usual and would receive no benefit, other than being able to more fairly compete with tax-exempt hospitals.

The Michigan Veterinary Medical Association thanks you and the subcommittee for their efforts in attempting to resolve this very difficult problem. For further comments, contact the designated representative of the MVMA, its executive director, P. A. Prescott, DVM.

Sincerely,

Carl L. Welti, DVM
President

Before the
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

TESTIMONY OF

RICHARD M. SWINNEY

NATIONAL COSMETOLOGY ASSOCIATION, INC.

Mr. Chairman and Members of the Subcommittee:

I am Richard M. Swinney, president of the National Cosmetology Association, Inc. ("NCA"), and I appreciate this opportunity to present my Association's views on the discussion options regarding the applicability of the unrelated business income tax ("UBIT") to income received by tax-exempt organizations. NCA is a 501(c)(6) association representing almost 50,000 cosmetology professionals located throughout the United States.

At the outset, NCA wishes to compliment the Subcommittee on its comprehensive investigation of these complex issues. Clearly, the United States cannot afford to ignore abuses of the tax-exemption laws. However, NCA is seriously concerned that some of the measures identified by the Subcommittee will not merely address problems in this area but will unnecessarily and unfairly inhibit 501(c) organizations from pursuing legitimate, exempt functions. We therefore urge the Subcommittee to carefully evaluate its discussion options in light of these concerns. Any overly broad legislation would certainly cripple the ability of tax-exempt organizations, such as NCA, to pursue activities which benefit the public interest — activities which Congress has traditionally supported.

More specifically, NCA respectfully requests the Subcommittee to eliminate certain discussion options from further consideration, including proposals concerning the "substantially related" standard; the advertising cost allocation rule; royalties; trade show income; and the relationship between exempt organizations and their for-profit subsidiaries.

(1) "Substantially Related" Standard

Under current law, a tax is assessed on income from a trade or business that is regularly carried on by a tax-exempt organization if the conduct is not "substantially related" to the exempt purpose of the corporation. It has been proposed that the "substantially related" standard be replaced with a "directly related" test. NCA opposes this option because, as O. Donaldson Chapoton, assistant secretary for tax policy of the Department of Treasury, testified before this Subcommittee on May 9, 1988, "[s]uch a change would generate considerable uncertainty and confusion without necessarily changing the substance, or the administrability, of the standard in any significant way." Clearly, a "directly related" test is no more objective than the "substantially related" standard and does not have the benefit of numerous administrative and judicial interpretations. Given that it is the administration of this test, rather than the test itself, that has been the subject of criticism, NCA supports the Treasury Department's recommendation to retain the existing statutory standard.

An alternative option suggests that a determination be made as to whether every income-producing activity, when viewed in isolation, is tax-exempt. Once again, we support the position of Assistant Secretary Chapoton. In his view, "the 'substantially related' standard appropriately exempts many such activities from tax even though the activities would not warrant tax exemption standing alone." Using food and lodging as an example, he appropriately recognized that, although these activities are not "inherently exempt," the provision of such facilities "contributes significantly to the educational mission of most universities and in our view is appropriately exempt from tax." NCA agrees with the Department of Treasury on this issue and requests that this proposed option be abandoned because it is conceptually unsound.

Finally, NCA opposes the discussion option that would retain the "substantially related" test but assess the unrelated business income tax on certain identified conduct deemed to be "inherently commercial." It appears that the list included in the discussion options merely reflects complaints of the various interest groups that testified last June. Thus, there seems to be no underlying logic to the inclusion or exclusion of particular conduct and no consideration of the relationship between the activities and the exempt purpose of the organization. For example, the discussion options suggest that "off-premise" sales be subject to UBIT. However, NCA distributes its fashion trend materials as a result of mail and phone orders. These instructional materials, which show cosmetologists how to create the latest hairstyles, clearly serve the Association's purpose of furthering the technical education of members of the profession. In addition, NCA conducts tours to international hairstyling competitions so that cosmetologists can enhance their professionalism by observing the skills of the most creative artists in the world under competitive conditions. It should be noted that NCA does not conduct any other types of tours. Given that these activities further the exempt functions of the Association, NCA does not believe that "off-premise" sales, tours and other conduct should be subject to UBIT on a per se basis.

For the above reasons, NCA urges the Subcommittee not to alter the "substantially related" standard.

(2) Advertising Cost Allocation Rule

Another discussion option would limit an exempt organization's deductions from advertising income to only direct advertising costs and would thereby eliminate the deduction for the excess of readership costs over circulation income. As Assistant Secretary Chapoton acknowledged, this proposed allocation rule treats tax-exempt publications "less favorably" than journals produced by for-profit organizations. Thus, the proposal does not "level the playing field" between tax-exempt and taxable corporations; rather, it penalizes the work product of organizations designed to further educational, scientific and charitable purposes. In fact, if this proposal is enacted, it will undermine the ability of tax-exempt organizations to perform one of their primary functions — to provide pertinent information to their membership. Given that such information can take the form of articles as well as advertising, NCA opposes this proposed revision to the UBIT provisions.

(3) Royalties

Although current law does not tax royalty income under the unrelated business income tax provision, the Subcommittee proposes the application of UBIT "to royalties measured by net or taxable income derived from the property; or royalties received by an organization for use of property if such organization, or closely related organization, either (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property." NCA believes that any revision of existing law in accordance with the Subcommittee's discussion option is both unnecessary and inappropriate.

In NCA's view, existing regulations governing royalties are adequate to prevent any abuse of this privileged tax status. Currently, such income is only exempt from taxation if it is derived from the asset and if the exempt organization does not perform any services to obtain the income. Subject to such constraints, tax-exempt organizations have been free to earn nontaxable income from royalties paid to use the exempt organization's name or logo. Given that this type of licensing activity cannot be deemed to give tax-exempt organizations an unfair advantage over for-profit entities, it is improper to subject this passive income to taxation. Further, since the taxable licensee probably had to increase its prices in order to compensate for the royalties paid to the tax-exempt organization, it is likely that such licensees are at a price disadvantage vis-a-vis their direct competitors. For these reasons, NCA firmly believes that royalty income should not be subject to the unrelated business income tax.

(4) Trade Shows

According to the press release requesting public comment, the Subcommittee is considering modification of various piecemeal UBIT exclusions enacted since 1969. One such "piecemeal exclusion" identified in the option papers is the provision which codifies the tax-exempt status of income received from trade shows and conventions. NCA strongly objects to a revisitation of this issue which Congress has considered at length twice in recent years. Indeed, the original legislation on this issue was specifically targeted at overturning IRS revenue rulings which sought to tax such income. Given the recent congressional attention to this issue and the lack of evidence at recent hearings that such activity is subject to abuse, it seems entirely inappropriate for Congress to reconsider this provision.

Moreover, there is no substantive reason to do so. There can be no question that trade show activity furthers the tax-exempt purposes of nonprofit organizations. Not only do trade associations, like NCA, use such events to hold association meetings and to conduct educational seminars but the trade shows themselves provide an opportunity for members of an industry to learn about new developments, products and services. Clearly, such activities further the exempt functions of such organizations.

(5) Taxable Subsidiaries

The discussion options have various provisions which would affect the relationship between tax-exempt organizations and their taxable subsidiaries. First, it is suggested that "a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization." If this proposal is codified, such income would be subjected to greater taxation than the income earned by an identical for-profit corporation which did not happen to be affiliated with a 501(c) organization. Such increased tax liability would be incurred because exempt organizations are unable to use deductible expenses in the same manner as for-profit corporations. In general, exempt-function expenses cannot be used to offset UBIT. Because of the unfairness of such a policy, NCA urges the Subcommittee to abandon this proposal.

Second, the Subcommittee is considering aggregating the income and activities of controlled subsidiaries with their parent organizations to determine if the parent primarily serves tax-exempt functions. The press release implies that, if an adverse determination is given, the parent's tax-exempt status would be in jeopardy. NCA sees no reason for "piercing the corporate veil" on a per se basis merely because one entity is tax-exempt and the other is not. Any such wholesale disregard of the separate legal existence of corporate entities would only result in the taxation of activities which have traditionally been considered in furtherance of exempt purposes. Moreover, since unrelated business activities are already subject to UBIT, it is entirely inappropriate to obliterate the distinction between tax-exempt parents and their taxable subsidiaries. NCA therefore opposes this recommendation which does not address a particular abuse and which would threaten the tax-exempt status of organizations legitimately serving exempt purposes.

* * *

In conclusion, the National Cosmetology Association urges the Subcommittee on Oversight to carefully evaluate its proposals and to ensure that they do not unfairly circumscribe the activities of tax-exempt organizations to such an extent that these worthwhile organizations find it difficult to survive.

Thank you for your kind attention.

Statement submitted by
National Easter Seal Society
to the
House Ways and Means Committee
Subcommittee on Oversight
regarding the May 9, 1988
Hearing on the Unrelated Business Income Tax

Submitted by Joseph D. Romer, Director of Governmental Affairs

May 20, 1988

We are submitting this statement in connection with the hearing on the unrelated business income tax (UBIT) which was held on May 9, 1988. We request that these comments be included in the hearing record.

This statement is intended to supplement the statement submitted by the National Easter Seal Society on April 15, 1988 in response to Press Release No. 16, which set forth a list of "discussion options" regarding UBIT. We would like to reiterate, clarify and expand upon a few of the points made in our previous comments. We also want to raise some additional issues which have surfaced subsequent to our earlier submission.

We are very concerned about the impact of the proposal on the contributions received by our agency. Currently, the total contributed income of all Easter Seal Societies is about $85 million. These contributions enable us to provide health, rehabilitation and social services to persons with disabilities. Most of the people that we serve are poor and many of the services that we provide could arguably be a governmental responsibility.

One of our greatest concerns about the proposal is its impact on corporate support for Easter Seal programs. Currently, we receive about $12.5 to $13 million from corporations. Century 21 Real Estate Corporation, Safeway Stores, Inc., A&W Beverages, Inc., and Amway Corporation are among our major national corporate sponsors.

We engage in a wide variety of fundraising activities with our corporate sponsors. Some of these are national in scope, while others are initiated by a local affiliate and are limited to one state or community. The arrangements for these activities vary widely.

About $3 million of our corporate support is attributable to cause-related marketing or charitable sales promotions. Generally, these promotions involve an agreement under which a corporation advertises its support for Easter Seals and agrees to make a contribution for each product purchased or coupon redeemed. The corporation usually uses our logo, the lily, in advertising the product.

This type of fundraising activity has proliferated in recent years. Many charities are using this approach to raise money for human services programs.

Depending on how the promotion is structured, income from this activity may be deemed a contribution or a royalty. We believe that the Subcommittee proposal to narrow the royalty exclusion would apply to many of these charitable sales promotions and jeopardize this type of activity as a fundraising tool for Easter Seals and many other charities. The potential tax liability is staggering.

Another proposal item which troubles us is the repeal of the "regularly carried on" test. This would affect special event fundraising, an integral part of the Easter Seal campaign. We raise an estimated net amount of $9 million from special events, which include sporting events, raffles, dinners and auctions, to name just a few. Special event fundraising is the fastest growing income source for our organization.

If the "regularly carried on" test is repealed, it appears as if income from this type of fundraising activity will be taxed, unless the goods or services sold are donated or all services are provided free. Although some members of the Subcommittee have indicated that they do not wish to tax special event fundraising, the Congress is likely to get that result if the "regularly carried on" test is abolished.

Your proposal to apply UBIT to travel and tour services would affect our transportation programs. In some communities, we arrange recreational or educational trips for persons with disabilities. In some cases, we provide local transportation to persons who are inadequately served by public transportation or whose physical limitations preclude the use of inaccessible public transit. Individuals are brought to medical appointments, congregate meal facilities, senior citizen centers and similar destinations and returned to their homes. We believe that this type of activity is clearly within the purview of our mission and should remain tax-exempt.

In our previous statement we pointed out several other Easter Seal activities which would be affected by the Subcommittee proposal. These include the following:

- health screening and other "routine testing"
- sales and rental of medical equipment
- homebound programs as they related to gift shop income
- rental of donor lists
- affinity card programs
- distribution of low cost items incidental to solicitations

In the aggregate, the proposed changes in the application of UBIT would create a huge tax liability for the Easter Seal organization. It would substantially reduce funds available for services such as physical, occupational and speech therapy, audiological services, vocational training, recreation, and transportation for persons with disabilities. Money heretofore used to purchase braces, walkers and wheelchairs would be used to pay federal taxes.

We do not believe that the Subcommittee is justified in proceeding with a proposal as far-reaching as the one outlined in Press Release No. 16. As the Department of the Treasury witness indicated in his statement "there is little empirical evidence regarding either the behavior of exempt organizations in competition with taxable businesses or the response of taxable businesses to such competition." In the absence of hard data, we do not think that the Subcommittee should proceed with legislation which goes beyond improvements in reporting, enforcement and compliance under the current relatedness test. Anecdotes and the testimony of some business interests hardly seem sufficient justification to threaten the viability of Easter Seals and thousands of other reputable charities which serve the public interest in so many ways. Virtually, every major charitable organization in the country shares our concern about the Subcommittee proposals.

Despite assurances by the Subcommittee Chairman during the hearing that he seeks only to correct abusive situations, we believe that our programs and fundraising efforts are in jeopardy. Current law relative to the applicability of UBIT is murky and the Subcommittee proposal, as it now stands, is very ambiguous. This makes it extremely difficult for the nonprofit sector to completely assess the potential impact of the list.

As the U.S. Chamber of Commerce said in its April 14, 1988 statement, "the difficulties inherent in reconciling the interests of the numerous parties involved in this issue are compounded by the complexity and sheer number of discussion items presented." The Chamber correctly pointed out that a number of the discussion items were raised for the first time in the March 31, 1988 Press Release. Although the hearing held last year was lengthy, it was general in scope, with nothing concrete in terms of legislation for the witnesses to comment on. Therefore, we believe that the Subcommittee should exercise extreme caution in its deliberations and postpone consideration of any changes in the standards for UBIT or the application of UBIT to specific nonprofit activities until the next Congress.

In the meantime, we have a recommendation. We urge the Subcommittee to draft specific legislative language in lieu of the general "discussion options" which were released in March. The draft should include a thorough explanation of each of its provisions, expressing legislative intent in terms of what activities are being targeted by the legislation and what activities would remain tax-exempt. Solicit the Department of the Treasury's comments and give charities and other tax-exempt organizations an opportunity to thoroughly analyze the proposal. This will insure both fairness and the avoidance of inadvertent consequences. By proceeding in this way, all the parties concerned, including the members of the Subcommittee, will have a clear understanding of the impact of the legislation.

NATIONAL GUARD ASSOCIATION OF THE UNITED STATES

ONE MASSACHUSETTS AVENUE, NORTHWEST • WASHINGTON, D.C., 20001 • (202) 789-0031

24 May 1988

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

On behalf of the members of the National Guard Association, I welcome this opportunity to provide additional comments relative to the Subcommittee on Oversights' review of unrelated business income tax.

I want to focus on one critical issue which was addressed in the statement of the Assistant Secretary of the Treasury during your Committee hearing on 9 May. That issue is the proposal to tax gross advertising revenue, allowing a deduction only for direct advertising costs. Such a provision would certainly be inequitable in that legitimate business expenses necessary to earn that advertising income would not be allowed to reduce the taxable base. This is contrary to common tax policies and normal business practices. It puts the non-profit organization at a distinct disadvantage.

This change would not provide equity; it would not provide a "level playing field;" and it would add an unwarrented tax burden to non-profit associations. For these reasons, we request that this option not be included in your recommendations to the full Committee.

Thank you for this opportunity to express our views on this most important matter.

Sincerely,

LA VERN E. WEBER
Lieutenant General, NGUS (Ret.)
Executive Director

Before the
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

STATEMENT OF

DENNIS C. DIX

OUTDOOR POWER EQUIPMENT INSTITUTE

Mr. Chairman and Members of the Subcommittee:

My name is Dennis C. Dix and I am the executive director and chief operating officer of the Outdoor Power Equipment Institute ("OPEI"). OPEI is a trade association composed of manufacturers of consumer and commercial outdoor power equipment, and their suppliers. Founded in 1952, this 501(c)(6) association fosters the economic interests of its members by providing worldwide industry economic information, sponsoring the industry's international trade show, promoting the safe and effective use of outdoor power equipment, and representing the members' interests in legislative and government affairs. In addition, OPEI serves as a forum for the exchange of ideas and information about the outdoor power equipment industry.

I appear here today because this Subcommittee is considering a recommendation which would impose the unrelated business income tax ("UBIT") on revenues derived from trade shows. OPEI vigorously opposes this proposal and urges the Subcommittee to reject any attempts to modify current law on this issue. At present, income from "qualified trade show and convention activities" received by trade associations that are tax-exempt under section 501(c)(6) of the Internal Revenue Code is not subject to taxation. For the following reasons, OPEI firmly believes that this statutory provision has a sound policy basis. It should therefore not be altered or repealed.

At the outset, let me describe the trade show sponsored by OPEI. The event features new products and innovations for the consumer lawn and garden market in the United States and around the world. "Green industry" consumer retail sales in the United States totaled $17.5 billion last year, according to the National Gardening Survey conducted by the Gallup Organization — an increase of 23 percent from 1986. The survey also noted that 59 percent of the households in the United States do their own lawn and garden care. Held at the Kentucky Fair and Exposition Center in Louisville, Kentucky, the show includes outdoor power equipment (such as walk-behind and riding mowers, lawn and garden tractors, snow throwers, tillers, shredder/grinders, and component parts), and other quality landscaping and yard care products for the consumer marketplace, including cultivators, and accessory items.

The show was started in 1984, and is designed to attract domestic and foreign trade buyers (including representatives of home and garden centers and hardware chain stores), manufacturers, distributors and dealers. Over the years, the show has more than doubled in exhibit size and participation, and has become a "show place" for the industry. In 1987, the International Lawn, Garden & Power Equipment Expo attracted more than 22,000 participants from all 50 states and more than 60 countries. It was one of the top five trade shows in the country, according to size of exhibit space.

New Products

As confirmed by independent surveys of attendees, the main attraction of the show is new products. Visitors to the OPEI show are able to view entire lines of innovative products in indoor facilities and are also able to "try before they buy" in an outdoor exhibit area the size of 13 football fields. This unique aspect of the show lets buyers test new products before offering them to consumers. The independent survey shows that about 90 percent of all attendees visit the outdoor exhibit area for this purpose.

Educational Programs

An extensive educational program is a major part of the event. Each year, topics concerning business management have been offered free-of-charge. See Exhibit 1. The "how-to" sessions have included programs on increasing sales, improving merchandising techniques, passing on the family business, utilizing new technology and computers, effective advertising and promotion, managing service departments, understanding new tax laws, targeting new customers, and increasing employee productivity. In addition, the show regularly includes events which provide instruction about the importance of safety in operating industry products, including presentations by insurance companies and the National Safety Council. The Expo has also offered a videotape feature about the safe operation of residential outdoor power equipment and an exhibit featuring a point-of-purchase safety kit for consumers. Each year, the best-attended seminar is the industry outlook for the upcoming selling season, which in 1988 will include retail sales data from the industry's first consumer telephone survey made possible by funding from the show.

Show Features

There are a range of show features each year which are designed to assist industry businesses in increasing profitability and serving consumers. For instance, the show included an Answer Center which provided merchandising information. It proved so popular with participants that a complete Model Store was subsequently created to show the latest in merchandising techniques and to enable top experts in the field to answer specific questions. The Expo also hosts an engine service repair competition which uses written and "hands-on" tests to evaluate competitors' abilities. This competition reinforces with monetary awards the value of quick, efficient, product repair skills.

Industry Support

OPEI's event has the support and participation of all five major trade associations in this industry. In fact, the benefits to the industry has been recognized by the trade press which has featured the Expo in a cover story more than a dozen times. Such coverage has been essential to attracting attendees. It is available because this industry-supported event is no longer sponsored by a particular trade publication, which had the detrimental effect of limiting press accounts in rival journals.

The exposition also provides an opportunity for the organizations sponsoring the show to hold association meetings to discuss industry matters. In addition, these events have generated meetings with representatives of the Consumer Product Safety Commission and has enabled these government officials to exchange information with industry executives and engineers on an informal basis.

* * *

Significantly, the trade show conducted by OPEI is precisely the type of event which Congress had in mind when it amended the Internal Revenue Code in the Tax Reform Act of 1976 to expressly exclude trade show income from taxation under the UBIT provisions. In that legislation, Congress specified that qualified convention and trade show activities were not encompassed by the "unrelated trade or business" definition if sponsored by a 501(c)(5) or 501(c)(6) organization that "regularly conducts as one of its substantial exempt purposes a show which stimulates interest in, and demand for, the products of a particular industry or segment of such industry." Tax Reform Act of 1976, § 1305(a), I.R.C. §§ 513(d)(1), (3) (1982).

The legislative history to this provision made it quite clear why Congress took this action. According to the report issued by the Senate Committee on Finance, the legislation was designed to statutorily reverse several rulings by the Internal Revenue Service which concluded that revenues should be taxed as unrelated business income if the exhibitors at an association's trade show were allowed to make sales on the convention floor and if a county fair association sponsored a horse race. S. Rep. No. 94-938, 94th Cong., 2d Sess. 602, reprinted in 1976 U.S. Code Cong. & Ad. News 3439, 4026. In the IRS' view, such events were "unrelated trade or business activities" even if they did not compete with commercial ventures. Id.

The Committee on Finance disagreed with this position, finding it "customary for tax-exempt organizations to provide entertainment, incuuding [sic] horse racing, at fairs and expositions in order to attract the public to the educational exhibits on display." Id. Further, the Committee emphasized that trade shows are used "as a means of promoting and stimulating an interest in, and demand for, their industries' products in general" and "educat[ing] their members regarding new developments and techniques which are available to the trade." Id. The Committee did not find that such exempt organizations "exploit[ed] their exempt status in order to compete unfairly with taxpaying organizations," especially since "[t]rade shows are generally conducted only by trade associations and not by taxpaying entities." Id. The U.S. Congress in adopting this part of the Tax Reform Act of 1976 agreed with the Senate Finance Committee's conclusions that trade show and convention activities of tax-exempt organizations are therefore "related" to the exempt functions of 501(c)(5) and 501(c)(6) corporations.

More recently, Congress confirmed its views on this issue when it enacted the Tax Reform Act of 1986. In that bill, the trade show exclusion described above was amended to extend its protection to any 501(c)(3) and 501(c)(4) organization that "regularly conducts as one of its substantial exempt purposes a show which stimulates interest in, and demand for, the products of a particular industry or segment of such industry or which educates persons in attendance regarding new developments or products and services related to the exempt activities of the organization." Tax Reform Act of 1986, § 1602, I.R.C. § 513(d)(3) (Supp. IV 1986). This amendment was deemed necessary because the 1976 Act only dealt with IRS rulings concerning trade show income received by 501(c)(5) and 501(c)(6) organizations. Because the Internal Revenue Service decided to impose the UBIT on similar income received by 501(c)(3) and 501(c)(4) organizations, Congress was required to legislatively circumscribe IRS actions. H. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-823, reprinted in 1986 U.S. Code Cong. & Ad. News 4075, 4911. In addition, the 1986 Act statutorily clarified that shows in which suppliers actually took orders qualified under these provisions and were thus not subject to UBIT. Id.

Based on the reasons set forth above, the Outdoor Power Equipment Institute urges this Subcommittee to abandon its efforts to repeal this beneficial exclusion. The U.S. Congress has thoroughly evaluated the applicability of UBIT to trade show income twice in recent years and has specifically reversed IRS policy on this issue. As OPEI has documented, trade shows further the exempt purposes of 501(c) organizations. They provide a forum for the exchange of information about new products and services and for educational seminars. As such, they foster the advancement of industry members. These activities are not within the scope of the "unrelated trade or business" provisions and thus should not be subject to the unrelated business income tax. The Outdoor Power Equipment Institute therefore recommends that the Subcommittee take no further action on this issue, thereby preserving existing law with regard to trade show income.

Thank you for your kind attention.

EXHIBIT 1

EXAMPLES OF SEMINARS AT THE INTERNATIONAL LAWN, GARDEN & POWER EQUIPMENT EXPO

Topic	Speaker
"Successful Retail Merchandising"	Rex Hoffman, Hoffman Power Equipment
"Do you Need a Computer in Your Lawn And Garden Store?"	William J. Przybysz, President, The Business Advisor, Inc.
"Preprinted Advertising Circulars"	Jim McConnell, Costitch-McConnell Advertising
"Managing the Service Department for Profit"	Michael L. Finn, Vice President Gardner, Inc.
"Guest Relations: The Customer is King"	Kristi Peterson, K.E. Peterson & Associates
"Take Advantage of the New Tax Laws"	Bart Basi, President, The Center for Financial and Tax Planning, Inc.
"Targeting Your Best New Customers"	Doris L. Walsh, Associate Publisher, *American Demographics*
"In House Servicing: Lucrative Or Ludicrous?"	Lawrence L. Steinmetz, PhD, President, High Yield Management, Inc. and author of *Nice Guys Finish Last*
"Protecting Your Business From Risk of Product Liability"	Robert L. Larsen, President, Insurance Administration Center
"Productivity Through People"	Bruce Merrifield, President, Merrifield Consulting Group
"Invest in Product Safety — Reap Sales Dividends"	Russell E. Marhefka, Director of Product Safety Programs & Standards Administration, National Safety Council
"The New Tax Laws and How They Affect Your Small Business"	Bart Basi, President, The Center for Financial and Tax Planning, Inc.
"The Changing Challenge to America"	Howard K. Smith, former CBS and ABC evening news anchorman
"Using Retail Technology to Increase Your Bottom Line"	Hal Marsolais, Vice President, Retail Services, National Retail Hardware Association
"Making New Employees A Valuable Asset — Finding, Training and Keeping Them"	Erick P. McCarty, President, Management Concepts, Inc.

Deloitte
Haskins+Sells

Suite 350
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2505
(202) 879-5600
ITT Telex: 4995732

Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
1105 Longworth House Office Building
Washington, D.C. 20515

June 17, 1988

Dear Mr. Chairman:

On behalf of United States Olympic Committee (USOC), I am submitting the enclosed comments on to the proposal pending before the Subcommittee to tax income from royalties derived from the licensing of logos or similar intangibles by exempt organizations. While the scope of this proposal has not yet been finalized, it appears that income from royalties derived from corporate sponsors, suppliers and licensees for the use of, or association with, the Olympic symbol of five interlocking rings may be subject to tax.

It is the USOC's purpose in submitting these comments to bring to your attention the major impact the proposal would have on the U.S. Olympic effort, and to urge either a modification of the proposal, or a special exception for the USOC. Royalty income has in the past represented over 70% of all revenue derived by the USOC to support the training and fielding of the United States Olympic Team. We estimate that the tax on the USOC's royalty income could run as high as $50 million over the four-year period 1989-1992. If this source of revenue were subject to tax it would have a devastating effect on our country's Olympic effort, since this amount represents approximately one-fifth of the USOC's budget during this period. We hope that the Subcommittee will recognize this as it deliberates.

It was our assumption that the original purpose of these proposals was to identify those areas in which exempt organizations were unfairly competing with commercial businesses, and was not intended to raise revenue. In this regard, the USOC accepts that it has certain activities that could be considered competitive (for example, the sales activities of the gift shop at the Colorado Springs headquarters and training facility, where souvenir merchandise is being sold).

Similarly, many of the technical provisions in the proposal relating to the identification and allocation of expenses are also expected to have some effect on the USOC's tax liability (for example, limits on deductions that can be taken against income from advertising sold in The Olympian, the USOC's magazine, will most likely increase the tax liability on the USOC's advertising revenue). We understand the purpose of these provisions, and find the proposals reasonable in the most part.

On the other hand, the proposal to tax royalties derived by an organization which either created the property producing the royalties, or which performs "substantial" services or incurs "substantial" costs in the development or marketing of the property is much too broad in scope. The proposal does not take into account whether unfair competition is in fact present, and stretches to find an "active business" where none exists. It appears to be motivated purely by revenue considerations, and, as stated previously, the impact in the case of the USOC would be devastating.

The USOC therefore urges that the scope of the royalty proposal be scaled back to deal with specific situations involving clear cases of unfair competition, or that a special exception be given for the USOC's royalty income derived from the licensing of the Olympic rings. The enclosed memorandum discusses these points in detail with specific emphasis on the legislative history related to various enactments of Congress recognizing the uniqueness of the USOC's situation.

Thank you,

Randall Snowling

Randall Snowling
National Director, National Foundation
and Exempt Organizations Practice

UNITED STATES OLYMPIC COMMITTEE

COMMENTS ON

PROPOSAL TO TAX ROYALTY INCOMES
AS UNRELATED BUSINESS TAXABLE INCOME

BEFORE THE

OVERSIGHT SUBCOMMITTEE OF
THE HOUSE WAYS AND MEANS COMMITTEE

June 16, 1988

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I. Summary of Position

The USOC's position is that either the recommendations before the subcommittee to tax royalties should be narrowed to deal only with specific cases where the tax free status of royalty income gives the recipient a competitive advantage, or that a special exception should be provided for the Olympic Committee recognizing its unique mandate from Congress to fund and support the U.S. Olympic Team.

I. The proposal is too broad in its scope and could tax the USOC's royalties, which are not derived from a competitive business activity.

When the unrelated business tax was enacted in 1950, the stated purpose was clearly to put businesses conducted by exempt organizations in the same position in terms of paying tax as the taxable companies with whom they were competing. It is also understood that the major thrust of the proposal before the Subcommittee is to review the scope of the competitive business activities of exempt organizations, whether or not related to their exempt purpose.

The USOC contends, for the following reasons, that the proposal is overly broad and would subject the USOC's royalty income to substantial tax liability when it is not engaged in a competitive business:

- The licensing of the Olympic rings and other intangibles associated therewith is not a competitive activity. While it is clear that licensees may use the symbols in competitive commerce, the USOC is not a participant in that commerce. The USOC does not manufacture products, endorse them, or otherwise become involved in control of the business conducted by its contributing sponsors. The USOC merely makes available the right to associate with the goodwill and international renown represented by the Olympic name and rings, and in so doing is not engaged in a competitive activity.

- The bulk of the USOC income is derived from corporate sponsors and suppliers (someone who provides equipment rather than money). In exchange, corporate sponsors and suppliers receive the right to associate with the Olympics, (e.g., "Coca Cola is a proud sponsor of the U.S. Olympic Team"). This association does not relate to the sale of any particular product, but rather associates the company with the team's goodwill. While the association is of apparent value to the sponsor, that value is not quantifiable and has a donative element.

- The proposal suggests an overly broad standard based on providing "substantial" services or incurring "substantial" costs relating to the property producing the royalty income. The standard ignores whether any competitive advantage or abuse is present. While the USOC would contend that its activities relating to its fund-raising operation are not "substantial" when compared to its activities relating to the Olympic and Pan American Games, it is impossible to tell how this test would actually be administered.

- The USOC does not base its royalties on taxable or net book income because such arrangements entail undue risk and involvement with manufacturers.

2. The USOC is a unique organization and should be granted a special exception.

The USOC plays a unique role as the official United States representative to the International Olympic Committee (IOC), a role which Congress has consistently recognized. In this regard, if a broad provision is adopted taxing royalty income, a special exception should be provided for the USOC.

- The USOC was directly granted its charter as a patriotic society by the United States Congress, and is the only patriotic society to have a specific statue recognizing its right to authorize the use of its logo as a source of funding.

- The right to raise revenues through license royalties was a tradeoff in the Amateur Sports Act of 1978 in lieu of direct Government funding.

- On numerous occasions in recent years the Congress has recognized the unique status of the USOC, including:
    - The Olympic Commemorative Coin Act of 1982
    - The Counterfeit Act of 1984
    - The 1988 Commemorative Olympic Coin Act

- The USOC as the United States representative in the Olympic Games the IOC plays an important role in the foreign relations of this country.

- The USOC is the only national committee among the over 160 national committees recognized by the IOC which does not receive direct Government funding.

- **The Treasury Department in testifying before the Senate Finance Subcommittee on Taxation and Debt Management, has recognized the uniqueness of the USOC and the Olympic mission, in distinguishing it from other tax-exempt charities desiring similar favorable treatment.**

3. **The tax liability imposed by the proposal would have a disastrous effect on the U.S. Olympic effort.**

It is estimated, based on the budget prepared for the 1992 Olympic games, that the proposed tax on royalty income could result in the USOC paying as much as $50 million in tax, or almost 20% of its total budget in the years 1989-1992. Even if the proposal was intended as a revenue provision, which the Subcommittee has stated is not the case, royalties would be unduly taxed. Since the USOC royalties are not derived from the active conduct of business there would be few allowable deductions, thereby magnifying the impact of the proposal.

II. Background

The USOC was organized in 1921, replacing a more informal organization that predated the revival of Modern Olympic Games in 1896. The USOC is our National representative to the IOC, and together they have used the word "Olympic" to identify their association with the Olympic movement since at least 1896. Under the IOC charter the USOC has the sole authority to represent the United States at the Olympic Games. The charter also requires the USOC to safeguard the "Olympic Movement and Sport" -- including protection of the use of the word Olympic and the symbols associated therewith.

In 1950 the USOC was formally granted a charter by the U.S. Congress as a Patriotic Society.[1] The enactment clearly recognized the USOC as having the royalty income derived from the leasing of the Olympic rings and associated intangibles. The Charter was revised by the Amateur Sports Act of 1978, which preserved the USOC's responsibility for financing the United States participation in the Olympics.[2].

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[1] Act to Incorporate the United States Olympic Association, 64 Stat. 899 (Sept. 21, 1950).

The Amateur Sports Act of 1978 was enacted in response to a study conducted by the President's Commission on Olympic Sports, which had been established to deal with perceived organizational and factional problems in coordinating this country's Olympic effort.[3] The prohibition from engaging in business for pecuniary profit or gain likewise was preserved in the revised statute.[4] This was recognized by the Second Circuit in a 1984 decision, which stated:

> The fundamental purpose of the Act was to safeguard the USOC's ability to raise the financial resources that are a critical component of America's capacity to send world class amateur athletes into international competition without the massive government subsidies enjoyed by competitors from other nations.[5]

To fulfill this financial responsibility, Congress enacted a special statutory provision in the Amateur Sports Act, which extended to the USOC the right to authorize contributors and suppliers of goods and services approved by the USOC to indicate in advertising the nature of their relationship with the USOC and the United States Olympic Team:

(1) That they are contributors sponsoring the United States Olympic Team;

(2) That they are suppliers of goods or services furnished to the United States Olympic Team;

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[2] 36 U.S.C. §375(a)(3), P.L. 95-606 (Nov. 8, 1978).

[3] The Final Report of the President's Commission on Olympic Sports, U.S. Govt. Printing Office, Wash., D.C. (Jan. 1977).

[4] 36 U.S.C. §378, P.L. 95-606 (Nov. 8, 1978).

[5] United States Olympic Committee v. Intelicense, 737 F.2d 263, 264 (2d Cir. 1984), cert. denied, 469 U.S. 982 (1984).

(3) That their products are approved by the USOC as licensed merchandise; or

(4) That the contributed or supplied products are used by the USOC as a benefit in kind.[6]

Pursuant to the Amateur Sports Act 1978, the USOC is organized into five levels of membership. The first level is consists of the 37 national governing bodies (National Rifle Association, Amateur Basketball Association, Gymnastics Federation, U.S. Figure Skating Association, U.S. Modern Pentathlon and Biathlon Association, etc.) comprising all the sports that are represented on the Olympic and Pan American programs. Each of these national governing bodies is charged with the responsibility for the coordination and development of their sports at the novice, intermediate, national and international levels.

The second level is comprised of multi-sport organizations including: The Amateur Athletic Union; American Alliance for Health, Physical Education, Recreation and Dance; Association for Inter-collegiate Athletics for Women; Catholic Youth Organization; Jewish Welfare Board; National Association of Inter-collegiate Athletics; National Collegiate Athletic Association; National Council of YMCA's; National Explorer Division of the Boy Scouts of America; National Federation of State High School Associations, National Junior College Athletic Association and U.S. Armed Forces. Multi-sport organizations conduct national programs in many sports and conduct a wide range of national sports competitions.

The third level is comprised of national governing bodies whose sports are not currently on the Olympic or Pan American Games programs, but which are widely practiced in this and other countries (e.g., tae kwon do).

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6 Section 110(b) of the Amateur Sports Act of 1978, 92 Stat. 3048, codified at 36 U.S.C. §380(b) (repealing act of Sept. 27, 1950).

> (b) The [USOC] may authorize contributors and suppliers of goods or services to use the trade name of the [USOC] as well as any trademark, symbol, insignia, or emblem of the International Olympic Committee, or of the [USOC], in advertising that the contributions, goods, or services were donated, supplied or furnished to or for the use of, approved, selected, or used by the [USOC] or United States Olympic or Pan-American team or team members.

The fourth level of national organization consists of those which conduct sports for the disabled (e.g., the Special Olympics). Finally, the fifth level is comprised of State Olympic organizations with representatives in every state. These organizations are comprised of volunteers whose principal purpose is to conduct local fund raising for the benefit of the United States Olympic Committee and its many programs.

The Amateur Sports Act further charged the USOC with the task of coordinating and developing amateur athletic activity in the United States which directly relates to international amateur athletic competition. In this capacity the USOC also has jurisdiction over all matters pertaining to the participation of the United States in the Olympic and Pan-American Games and the organization of such games when they are held in the United States.

The objects and purposes of the United States Olympic Committee as enumerated by Congress are to:[7]

(1) establish national goals for amateur athletic activities and encourage the attainment of those goals;

(2) coordinate and develop amateur athletic activity in the United States directly relating to international amateur athletic competition, so as to foster productive working relationships among sports-related organizations;

(3) exercise exclusive jurisdiction, either directly or through its constituent members or committees, over all matters pertaining to the participation of the United States in the Olympic Games and in the Pan-American Games, including the representation of the United States in such games, and over the organization of the Olympic Games and the Pan-American Games when held in the United States;

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[7] 36 USC §374.

(4) obtain for the United States, either directly or by delegation to the appropriate national governing body, the most competent amateur representation possible in each competition and event of the Olympic Games and of the Pan-American Games;

(5) promote and support amateur athletic activities involving the United States and foreign nations;

(6) promote and encourage physical fitness and public participation in amateur athletic activities;

(7) assist organizations and persons concerned with sports in the development of amateur athletic programs for amateur athletes;

(8) provide for the swift resolution of conflicts and disputes involving amateur athletes, national governing bodies, and amateur sports organizations, and protect the opportunity of any amateur athlete, coach, trainer, manager, administrator, or official to participate in amateur athletic competition;

(9) foster the development of amateur athletic facilities for use by amateur athletes and assist in making existing amateur athletic facilities available for use by amateur athletes;

(10) provide and coordinate technical information on physical training, equipment design, coaching, and performance analysis;

(11) encourage and support research, development, and dissemination of information in the areas of sports medicine and sports safety;

(12) encourage and provide assistance to amateur athletic activities for women;

(13) encourage and provide assistance to amateur athletic programs and competition for handicapped individuals, including, where feasible, the expansion of opportunities for meaningful participation by handicapped individuals in programs of athletic competition for able-bodied individuals; and

(14) encourage and provide assistance to amateur athletes of racial and ethnic minorities for the purpose of eliciting the participation of minorities in amateur athletic activities in which they are underrepresented.

In addition, Congress granted specific power to the USOC including the power to: [8]

(1) serve as the coordinating body for amateur athletic activity in the United States directly relating to international amateur athletic competition;

(2) represent the United States as its national Olympic Committee in relations with the International Olympic Committee and the Pan-American Sports Organization;

(3) organize, finance, and control the representation of the United States in the competitions and events of the Olympic Games and of the Pan-American Games, and obtain, either directly or by delegation to the appropriate national governing body, amateur representation for such games;

(4) recognize eligible amateur sports organizations as national governing bodies for any sport which is included on the program of the Olympic Games or the Pan-American Games;

* * * * *

Particular attention is called to 36 U.S.C. §375(a)(3) above and the power granted to "organize, finance, and control" this country's participation in the Olympic Games.

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8 36 U.S.C. §375.

III. Arguments

The following are the arguments and underlying legal authority the USOC would advance in support of a narrowing of the royalty proposal, or an exemption therefrom.

1. Income from the licensing of Olympic rings is not the type of income which should be subject to taxation.

   a. The Olympic rings were not developed or purchased by the USOC for commercial purposes.

The Olympic rings were not developed by the USOC for commercial purposes. The USOC is bound by Rule 24 of the IOC Charter which requires the various National Olympic Committees to protect the Olympic name and insignia from misuse and misrepresentation. Thus, when the USOC was chartered by Congress in 1950, a provision was added making it a misdemeanor offense for any party to use the Olympic name or insignia without the consent or permission of the USOC. This provision is explained in the following language from the Senate Report:

> One particular problem which the association is faced with is the protection of the Olympic insignia. The International Olympic Committee holds each national Olympic committee responsible for protecting the Olympic name and insignia from unlawful use. Thus, in order to protect its name and insignia from being abused, section 9 of the bill provides that it would be a misdemeanor for any person to falsely or fraudulently represent himself to be a member or agent of the organization for the purpose of soliciting, collecting, or receiving money or material, or to wear the insignia thereof for a fraudulent purpose or to use it fraudulently in connection with a commercial purpose.[9]

The protected Olympic insignia were described in section 9 of the 1950 Act, which provided, in part:

> It shall be unlawful for any person, corporation, or association, other than the United States Olympic Association or its subordinate organizations and its duly authorized employees and agent for

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[9] S. Rep. 2926, 82d Cong., 2d Sess., 1 (Aug. 7, 1950).

> the purpose of trade, theatrical exhibition, athletic performance, and competition or as an advertisement to induce the sale of any article whatsoever or attendance at any theatrical exhibition, athletic performance, and competition or for any business or charitable purpose to use within the territory of the United States of America and its exterior possessions , the emblems of the United States Olympic Association consisting of an escutcheon having a blue chief and vertically extending alternate red and white bars on the base with five interlocked rings displayed on the chief, or any other sign or insignia made or colored in imitation thereof, or the words "Olympic", "Olympian", or "Citius Altius Fortius" or any combination of these words . . .[10]

The Amateur Sports Act of 1978 recodified the USOC charter, while leaving intact its essential mission and purpose. Thus the responsibility of the USOC for financing participation by the United States in the Olympics was preserved, as was the original prohibition against engaging in business for pecuniary profit or gain. However, under the Amateur Sports Act, the provisions protecting the Olympic insignia were greatly enhanced, replacing the misdemeanor penalty provided in the original Act with a civil course of action vested in the USOC, and enabling the USOC to earn revenues through licensing the permissive use of these insignia by specifically designated organizations.

However, it must always be borne in mind that the provisions contained in Section 380 also serve the primary purpose of protecting the Olympic insignia from misuse and misappropriation as required by the IOC. These insignia are the property of the IOC -- not of the USOC. The USOC as a member of the National Olympic Committee of the IOC, is merely entrusted with the use and protection of these insignia. Furthermore, these insignia were never developed or purchased with a profit-making motive in mind, but rather to serve as a unique identifier of the Olympic movement and ideals throughout the world.

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10 64 Stat 899, ch. 975, §9 (Sept. 21, 1950).

b. **Since the Olympic insignia have a unique significance, in licensing the use of these insignia the USOC was not competing with any other taxable or nonprofit entity or otherwise engaging in a active trade or business.**

A major concern of Congress in originally enacting the unrelated business income tax (UBIT) in 1950, and apparently underlying the present proposals to expand the scope of the UBIT, was that a few exempt organizations might be able to use their status to operate active businesses paying no tax, thereby competing unfairly with for-profit corporations engaged in similar lines of business. Prior to 1950 the legal test as to whether a business could operate tax-free was that the "destination of income" determined whether it would be taxed (i.e. whether income was ultimately destined for charitable purposes). This test, which was originally enunciated by the Supreme Court in a 1924 case[11], reached its highwater mark when the third Circuit Court of Appeals ruled that income earned by the Mueller Macaroni Co. was tax-free since the company was owned by New York University.[12]. The court reasoned that since the benefit therefrom would ultimately be realized by a tax exempt educational institution the company's income was also tax exempt.

Congress reacted to the outcome of cases such as *Mueller* with the unrelated business tax provisions which were directed at the problem of unfair competition created by the destination of income test:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section [501] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.[13]

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[11] *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924).

[12] *C. F. Mueller v. Comm'r*, 190 F.2d 120 (3d Cir., 1951).

[13] S. Rep. 2375, 81st Cong., 2d Sess., 37 (1950).

However, Congress also recognized that royalty income was passive in nature and represented little serious competition to taxable business:

> Dividends, interest, royalties, most rents, capital gains and losses and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.[14]

The unfair competition argument may indeed have some merit with respect to certain lines of commercial endeavor engaged in by both taxable as well as tax-exempt organizations (i.e., travel agencies; the sale of hearing aids or eye glasses; etc.) However, the licensing of the Olympic rings is not such a commercial activity. Because of the uniqueness of the USOC's mission, and the fact that the sole value of its name and insignia is in their signifying goodwill and patriotism on the part of those displaying them, the USOC is in no way competing unfairly with anyone through its licensing efforts. No other insignia, logo, or designation conveys quite the same significance to the general public as the five interlocking rings characteristic of the international Olympic movement! It is further worth noting that USOC incurs relatively few expenses in licensing its insignia. Unlike active businesses it therefore has few deductions to offset against its royalty income, thereby magnifying the impact of any potential tax liability.

c. The USOC license royalty income contains a donative element which cannot be quantified.

Corporate contributors, suppliers, and licensees make contributions to the USOC for a variety of reasons. While it can be assumed that corporate sponsors expect to achieve certain intangible benefits (i.e., goodwill), in many cases the association with the USOC and the display of the Olympic insignia may be an integral part of a company's marketing campaign. Thus, for instance, among the official sponsors of the 1988 U.S. Olympic Team, one might expect that a corporate sponsor such as Addidas (sporting apparel) would derive a more direct and tangible benefit from its sponsorship of the USOC than would a sponsor such as Friden Alcatel (manufacturer of shipping equipment), or CPC International (manufacturer of peanut butter and vegetable oil). However, it is often difficult to clearly identify the financial benefits derived by licensees from their use of the Olympic name and rings, and accordingly it is apparent that the gift element attached to both corporate and individual contributions cannot be quantified. If USOC licensing and royalty income were to be subject to taxation, it would involve -- at least to some extent -- the taxation of donative charitable contributions made by individuals and corporations. This would be completely inconsistent with the existing federal income tax policy of encourage charitable donations to public charities.

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[14] S. Rep. 2375, 81st Cong. 2d Sess., 30-31 (1950).

The point is simply that the Olympic insignia is a symbol of goodwill. It was not created for commercial purposes, and its subsequent use by merchants does not mean that the USOC is engaged in commerce.

2. The USOC is unique and can readily be distinguished from other tax-exempt organizations.

a. The USOC is inherently different from other exempt organizations.

The USOC, a federally-charter tax-exempt private corporation, is unique from the other 69 federally-created private corporations. (See 36 USC §1101). The key features that readily distinguish the USOC from these other organizations are:

- First, the United States' posture in the Olympic movement is one of the few activities where National and international prestige are at stake.[15]

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[15] See, e.g., Statement of Interest of the United States, Liang Ren-Guey v. Lake Placid 1980 Olympic Games, 72 A.D. 2d 439, 424 N.Y.S. 2d 535 (N.Y. App. Div.), aff'd, 49 N.Y. 2d 771, 403 N.E. 2d 178, 426 N.Y.S. 2d 473 (N.Y. 1980).

- Second, those few other charitable activities that involve national and international prestige, such as academic research leading to national and international awards, all receive substantial and continuing support from our federal government.

- Third, the USOC is the only federally chartered corporation that has been given goals and purposes to fulfill on behalf of the U.S. Government, but given no financial resources to implement the goals and purposes.

- Fourth, although the USOC tries to combat the use of sport for political purposes, the fact remains that sport and politics are often inextricably intertwined. For example, former President Carter made international sport an instrument of American foreign policy by asking the USOC not to send its team to Moscow in 1980. The USOC agreed because it was in the national security interest to do so. This makes our Olympic effort unique among the other great charities in the United States.

- Fifth, although the USOC does not desire to have federal monies, other charities in the United States do desire and receive it. Research on cancer and other diseases is funded by the government, and the National Endowment for the Arts and Humanities exists to fund excellent programs in other areas. In addition, the International Communications Agency (ICA) has historically funded ballets, orchestras and other similar cultural activities to travel all over the world. The ICA has done very little in the sports area because, as a matter of policy, it does not believe that sports are an important cultural activity. Almost all countries view sports as an important and integral part of overall cultural activities and most have a government ministry responsible for it. Given these conditions, the USOC must assume the responsibility in filling this void.

- Sixth, the USOC is not a member of the United Way, and, therefore, does not receive financial support from this vehicle.

b. The Congress has on numerous occasions recognized the uniqueness of the USOC by statute.

There are a number of legislative enactments in which Congress has singled out the USOC. This in no way reflects on the important role of other charities. Rather, it recognizes the unique role the USOC plays in promoting the goodwill of the United States abroad.

The key provision highlighting this recognition is, of course, the Amateur Sports Act 1978. Although the Act did initially provide a one-time grant to assist the USOC in accomplishing its reorganization, it was clearly understood that going forward there would be no permanent program of Government Assistance on an on-going basis:[16]

> It should be thoroughly understood that this is intended to be a one-time-only grant. The USOC has testified that it will not seek future funds from the Federal Government, and it is with the understanding that the committee included this section in the bill. The USOC also testified that these funds are needed as "seed money" to accomplish the reorganization which should encourage new and increased financial support from the private sector.
>
> By authorizing this appropriation, the committee is in no way advocating for a permanent program of Federal financial assistance to amateur athletics in this country. The United States distinguishes itself from many other countries by allowing amateur athletics to be a truly amateur in nature, free from Government funds and dominance. It is the committee's view that this approach to amateur

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[16] H. Rep. 95-1627, 95th Cong., 2d Sess., 1 (1978).

> athletics continues to be in the best interest of the United States; thus, these funds should not be used in any manner which might impinge on this policy.

However, in the end no federal funds were appropriated. It was understood that the specific statutory grant of authority to use the Olympic Rings would suffice. A specific statute authorizing exclusive use of the Olympic Rings by the USOC with the understanding that the Rings would be licensed to contributors and suppliers, but, there would not be direct Federal funding.

It was in this context that Congress enacted the Amateur Sports Act of 1978. It specifically reads as follows:[17]

> (b) Contributors and suppliers. The Corporation may authorize contributors and suppliers of goods or services to use the trade name of the Corporation as well as any trademark, symbol, insignia, or emblem of the International Olympic Committee or of the Corporation in advertising that the contributions, goods, or services were donated, supplied, or furnished to or for the use of, approved, selected, or used by the Corporation or United States Olympic or Pan-American team or team members.

> (c) Exclusive right of Corporation. The Corporation shall have exclusive right to use the name "United States Olympic Committee"; the symbol described in subsection (a)(1); the emblem described in subsection (a)(2); and the words "Olympic", "Olympiad", "Citius Altius Fortius" or any combination thereof subject to the preexisting rights described in subsection (a).

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17 36 U.S.C. §380.

The Act further provided in enumerating the USOC's powers, that it would have the power to "organize, finance, and control the representation of the United States" in the Olympic Games.[18]

Subsequently, In the Trademark Counterfeiting Act of 1984 Congress reinforced its commitment to the USOC's exclusive use of the Olympic rings, when it enacted criminal sanctions in 7 USC §2320 for the counterfeit use thereof.

A different form of government encouragement of private support occurred with the Olympic Commemorative Coin Act of 1982, which was enacted as a means of both commemorating the Los Angeles Olympics and providing financial support; as Representative Long of Louisiana stated:[19]

> Mr. Speaker, though there may be disagreement over the best method of marketing an olympic coin, there is no disagreement about the importance of minting an olympic coin. In July and August of 1984, Los Angeles will be the site of the XXIII Olympiad. It will be the first time in half a century that a city in the United States has served as host to this prestigious sporting event, and the first time in history any nation has been host to three Olympic games. Over 150 nations throughout the world are planning to compete before a worldwide audience that could number in the billions.
>
> An Olympic coin program is important in two respects. The tradition of minting special coins can be traced back centuries to the ancient Greeks. Throughout history, special coins played a role in generating enthusiasm and support for the games, and more recently, have helped fund the staging of the games so that countries from all over the world could participate.

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18 36 U.S.C. §375.

19 Cong. Record H-2413 (May 20, 1982).

> Second, the coin program plays an important role in providing support for the training of our athletes. This training is a long-term process. Financial support is critical to our ability to provide American youth of all ages and skills the opportunity to develop their athletic ability, and to build the pride and confidence important to compete in today's world. Without an effective Olympic coin program or the Los Angeles games, we would lose out on an important source of these funds.

The most recent example of Congressional action is the *1988 Olympic Commemorative Coin Act* designed to commemorate the participation of U.S. athletes in the 1988 Winter and Summer Games.[20]

Both Coin Acts are representative of the attitude of Congress that while direct Government funding is not available the Congress willingly supports and encourage private involvement. A tax on revenues from the Olympic logo is inconsistent with the direct encouragement Congress has given to the USOC to fund its activities through *public* activities such as the commemorative coin or the logo licensing. Would the proposal tax the funds the USOC receives through the sale of 1988 commemorative coins? After all, the coins do carry the Olympic logo. Surely Congress did not believe that the coin revenue would be taxed when the Commemorative Coin Act was passed in late 1987. Yet the broad scope and vagueness of the proposed tests would arguably apply the UBIT to the coin revenue as well.

It is also worth noting that in addition to various Congressional enactment that single out the USOC the Treasury Department has itself acknowledged the unique status of the USOC. In testimony before the Senate Finance Committee in 1981 the Hon. John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, made the following statement in answer to a question by Senator Packwood:[21]

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[20] P.L. 100-141, 107 Stat. 8 (Oct. 28, 1987) (codified at 31 U.S.C. §5112).

[21] Hearings before the Subcommittee on Taxation and Debt Management of the Committee on Finance United States Senate, 97th Cong., 1st Sess. 27 (Oct. 30, 1981).

> Senator Packwood: Don't you think there is almost a basic difference in kind between the Olympics and almost every other kind of charity you might want to have?
>
> Mr. Chapoton: When the Senators were testifying, that thought was apparent to me. Yes, there is a difference. I agree. (emphasis added.)

In this context we again urge that the Subcommittee recognize that Congress and the Treasury have repeatedly acknowledged the unique stature of the USOC, and that a special exception is warranted in the present case.

3. Taxation of Royalty Income would Severely Damage the Ability of the USOC to Fulfill its Role.

Corporate sponsorships, supplier contributions, royalties, licensing fees, television royalties are a major source of funding for the USOC. For the 1984-1988 quadrennium, royalty income alone accounted for over 75%, of total income. This income is essential if the USOC is to continue its programs.

As mentioned earlier, expenditures relating to the training and financing of the United States Olympic Team are just a small (but extremely visible) part of the mission of the USOC -- which is to support and develop amateur athletics in the United States. Other efforts of the USOC include special programs to enhance sports education in our schools, programs for the mentally and physically disabled, research in sports medicine, etc. During the past decade the USOC has restructured its organization, management and fund-raising. The USOC has:

- Established a national training center in Colorado Springs and a winter sports training center in Lake Placid where athletes of all skill levels can come and train or short periods of time with the USOC paying all the operating expenses;
- Established the National Sports Festival, a domestic multi-sport event paralleling the Olympic Games, which is held in all years except the Olympic year;
- Increased development grants to the various sports comprising USOC membership;

- Established a Job Opportunity Program which placed over 160 athletes in jobs with national companies that paid athletes fair market value for work but allowed the athletes time away from work with pay to train in their sports;

- Established a Sports Medicine Program the purpose of which is to provide medical information affecting athletic performance to coaches, officials and athletes and to reach out and coordinate the existing work being conducted in sports medicine nationwide;

- Established more effective coordination, communications and economies among member organizations. The USOC has provided free space and service to the national governing bodies at the Olympic Complex in Colorado Springs;

- Formed a Disabled in Sports Committee to assist the national organizations promoting sports for the disabled in effecting a broader scope in their programs and establishing closer liaison with the national governing bodies. Further, the USOC has included in its budget financial support to assist these organizations in establishing broader amateur sports programs which will generate maximum participation by the disabled.

The USOC is charged by Congress in its charter with providing these kinds of opportunities. Yet it cannot expand or accomplish its objectives if a major part of its financial support is suddenly subject to tax.

The imposition of federal income tax on the USOC's royalty and license income would have disastrous consequences for the USOC -- as well as for amateur sports in America. Based on a projected budget figures in the four-year period between 1989-1992 the USOC expects revenue of approximately $260 million from all sources. Approximately 60% of this amount is expected to come from corporate sponsorships and other sources that would most likely be subject to tax under the subcommittee's proposal. After deductions for direct expenses, which are not significant since the licensing program is not an active business, the tax liability, at a 34% rate, could run as high as $50 million.

A revenue shortfall of this magnitude could not be made up through an expansion of the USOC's existing funding program -- which relies primarily on licensing fees and royalties to generate income. All that the USOC asks is that its present funding efforts not be hampered by the imposition of an additional tax burden on its single most important source of revenue. In other words, the USOC desperately needs and is therefore asking for an exception from the existing proposal to tax unrelated business income generated by royalties and licensing fees from the Olympic insignia.

All of the USOC's funds have been raised from corporations, foundations and individuals, except for a small portion which was granted to the USOC by the federal government as a result of the negative impact on our fund-raising efforts caused by the USOC not electing to send a team to the 1980 Games in Moscow. However, financial needs continue to increase to meet the USOC's responsibility to provide and enhance the opportunities for the youth of our country.

If UBIT proposal to tax royalties were adopted, the USOC would be faced with the choice of either curtailing existing programs or seeking direct financial assistance from the United States government. If the former option were pursued, the American people would be the ultimate losers. If the latter option were pursued, then the United States government would be providing a financial subsidy to the USOC to offset the revenue loss due to taxes paid.

The USOC does not desire or seek financial assistance from the U.S. Government.

IV. Conclusion

The USOC respectfully requests the committee members to consider the adverse affect that the present proposals would have on the USOC. Specifically, the USOC urges that the recommendation before the subcommittee to tax royalties should be narrowed to deal only with specific cases where the tax free status of royalty income gives the recipient a competitive advantage vis-a-vis taxable for-profit entities.

The proposal uses an over broad standard based on providing "substantial" services and maintaining "substantial" costs relating to the property producing the royalty income. The standard ignores whether any competitive advantage or abuse is present, and will create administrative burdens.

The USOC contends that this proposal could subject the USOC's royalty income to substantial tax liability, even though the USOC is not engaged in anticompetitive business practices.

However, should the Subcommittee choose to enact this proposal, with the standard contained therein, the USOC urges as an alternative, that a special exception be provided for the USOC recognizing its unique mandate from Congress to promote all amateur sports in the U.S. and to support and fund the U.S. Olympic team.

THE UNIVERSITY OF MICHIGAN
ANN ARBOR, MICHIGAN 48109-1340
(313) 764-6270

ROBBEN W. FLEMING
Interim President

April 20, 1988

The Honorable J. J. Pickle
Chairman, Oversight Subcommittee
Committee on Ways and Means
U.S. House of Representatives
242 Cannon House Office Building
Washington, D.C. 20515

Dear Congressman Pickle:

Re: Unrelated Business Income Tax:
Response to Discussion Options

The University of Michigan welcomes the opportunity to comment on the preliminary discussion options regarding unrelated business income tax as outlined by the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives.

We have asked that our staff review the issues identified by the Subcommittee for discussion, and their comments have been summarized in the attachment to this letter.

In addition to the specific comments in the attachment, I would like to make a few general observations. Overall, The University of Michigan supports the efforts of the committee which is considering these issues and expects that universities would be able to participate in this process as appropriate.

The distinction between related and unrelated business activities is difficult to determine and standardize. We recognize this and believe that truly unrelated business activities should not be treated the same as related ones.

However, it should be remembered that many activities undertaken by universities result from the need to provide a proper setting for students involved in academic pursuits. Supplies and services provided to students by universities tend to reduce their educational costs. They are not intended to enrich the institution monetarily.

As in other relationships with the federal government, universities should be expected and permitted to retain and use their existing accounting systems and standards. Efforts to rationalize and control unrelated business activities should not result in a requirement that universities establish separate accounting systems for purposes of determining unrelated business income tax. If modified or enhanced reporting requirements are ultimately determined to be necessary, universities should be a party to the development of those modifications. There is precedent, in this respect, in the manner in which the federal government and universities worked together to develop sponsored research costing principles.

We believe that unrelated business activities should be self-supporting, not subsidized directly or indirectly by related activities and that they should be subject to full cost allocations. Anything less would result in a form of cost sharing and an inappropriate use of other resources.

We would hope to be able to preserve our tradition and mission of performing an effective combination of instruction, research and public service activities in our communities. These functions are interrelated, frequently performed by the same staff in the same facilities and often simultaneously. These are funded and supported from a variety of sources, each benefiting in a variety of ways.

It would be awkward and unproductive for us if one of these functions were to be singled out for special treatment because of potential income tax issues. In the case of pharmaceutical testing and trials, for example, a decision to subject all of this activity to income tax may not be in the public's best interest. In many instances, universities are the only source for such sophisticated analysis, and the resources used for this are involved in related basic research and instructional programs.

In recent years, universities have taken the results of basic research activities on into the various stages of development and economic exploitation through licensing agreements and the like. Typically, net income from these activities is reinvested in further research and program enhancement. Subjecting royalties and license fees to income tax may unnecessarily inhibit this activity. We would be concerned that not all such activities be viewed as unrelated.

We would be interested in the results of your deliberations and would appreciate the opportunity to comment further at the appropriate time.

Sincerely,

R. W. Fleming

Robben W. Fleming

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Enclosure

THE UNIVERSITY OF MICHIGAN

COMMENTS RE: 3-30-88 DISCUSSION OPTIONS FOR CHANGING THE UNRELATED BUSINESS INCOME TAX

I. SUBSTANTIALLY RELATED STANDARD

PROPOSED ACTION: Retain the standard, but explicitly treat specified activities as unrelated and tax those activities whose nature and scope are considered to be inherently commercial rather than charitable.

OVERALL COMMENT TO WAYS AND MEANS ON POINT I: We recommend that "inherently commercial" be changed to "exclusively commercial".

A. Gift Shops and Bookstores

1. In General

PROPOSED ACTION: Limit exclusions from UBIT to articles of an educational nature which relate to the organization visited, sale of guides to the exhibits and events, sale of articles generally used by inpatients at the hospital gift shop and low cost mementos and convenience items. Apply UBIT on income from all catalog or mail/phone order sales or other types of off-premise sales except in de minimis amounts. It is not clear if all sales, or only selected sales from University gift shops would be exempt.

COMMENT TO WAYS AND MEANS: We support the stated options for both on-premise and off-premise sales. We suggest the dollar ceiling on the cost of a low cost memento and convenience items be initially set at fifty dollars ($50) per item, and that it be increased periodically to keep pace with inflation. We strongly believe that all items, regardless of cost, should be exempt from UBIT, if directly related to the primary purposes of the organization (e.g. books and one computer per year at a University). We believe that all low cost items, especially at hospital gift shops, be exempt from UBIT. Hospital gift shops, and University shops, are physically located so as to be inconvenient to everyone except patients, patient visitors, students, and other directly related individuals.

2. College Bookstores

PROPOSED ACTION: Apply UBIT to income from all sales unless such items are furtherance of the conduct of educational programs or low cost items with some dollar cap. Apply UBIT to income from sales of computers to persons other than students or faculty or to an excess of one computer per student or faculty member per year.

COMMENT TO WAYS AND MEANS: We support the stated options, except that in the case of computer sales, we believe the sale of one computer per year to students and faculty should be extended to also include all University staff (e.g.: a non-faculty Researcher or Accountant may have as great a need for a computer as a faculty member). We suggest the dollar ceiling on the cost of low cost bookstore items be initially set at fifty dollars ($50) per item, and that it be increased periodically to keep pace with inflation. This fifty dollar ($50) limit would apply to convenience items only. Items purchased for educational and research purposes should be exempt.

B. Medical Equipment and Devices (including hearing aids, portable x-ray units, oxygen tanks), Laboratory Testing, and Pharmaceutical Drugs and Goods

PROPOSED ACTION: Apply UBIT to income from sales or rentals or fees to outpatients for medical equipment and devices, laboratory testing, pharmaceutical drugs and goods.

COMMENT TO WAYS AND MEANS: We recommend the following sales be exempt from UBIT: i) sales to patients, including all patients on an outpatient basis for required continuity of care, and ii) all sales to other hospitals or other medical practitioners or entities, where the services or articles sold are not readily available locally or are nonroutine, esoteric, or related to the organization's teaching or research purposes.

C. Health, Fitness, Athletic and Recreational Activities

PROPOSED ACTION: Apply UBIT to income from health/fitness/athletic and recreational activities unless the program is available to a reasonable cross section of the general public such as by scholarship or fees based on community affordability.

COMMENT TO WAYS AND MEANS: We support the stated option.

D. Travel and Tour Services

PROPOSED ACTION: Apply UBIT to income for all travel and tour services except those provided for faculty and students as part of a curriculum in their degree program.

COMMENT TO WAYS AND MEANS: We support the stated option.

E. Restaurants and Food Service

PROPOSED ACTION: Apply UBIT to income from adjunct food service sales unless the services are : 1) provided on the premises of the organization, and 2) primarily for the benefit of students, faculty, visitors, or employees of the organization.

COMMENT TO WAYS AND MEANS: We support the stated option.

F. Veterinary Services

PROPOSED ACTION: Apply UBIT to income from veterinary services.

COMMENT TO WAYS AND MEANS: We support the stated option.

G. Hotels

PROPOSED ACTION: Apply UBIT to income from hotel facility which is patronized by the public, except to the extent operated in furtherance of the organization's exempt purpose.

COMMENT TO WAYS AND MEANS: We support the stated option.

H. Routine Testing

PROPOSED ACTION: Apply UBIT to income from routine testing with exceptions for federal/state mandated activity and laboratory testing which is part of the student educational training program.

COMMENT TO WAYS AND MEANS: We support this option provided that there is no adverse effect on research activities and no attempt is made to redefine "research" as "testing." We believe that it is in the best interest of the country to very broadly define research, and very narrowly define "testing" so as not to create disincentives to research, with the result of fewer technological gains nationally. We also recommend that wording be included that UBIT not be applied to "testing involving services, facilities, or capabilities which are not easily accessible in the for-profit sector", since these activities by definition do not compete with the for-profit sector.

I. Affinity Credit Card/Mail-Order Catalog Endorsements

PROPOSED ACTION: Apply UBIT to income earned by the organization from its sponsorship of bank credit cards or mail order catalogs.

COMMENT TO WAYS AND MEANS: We support the stated option.

J. Advertising Income and Cost Allocation Rules

1. Advertising Income

PROPOSED ACTION: Apply UBIT to income from advertising in general to reduce interpretation of the "majority" use of the magazine for education or related activities.

COMMENT TO WAYS AND MEANS: We support the stated option.

2. Advertising Cost Allocation Rule

PROPOSED ACTION: Allow exempt organization to deduct from advertising only direct advertising costs, not circulation or program/directory/magazine production costs.

COMMENT TO WAYS AND MEANS: We disagree with this option. Again, if an activity is commercial-like, it should be allowed the same full costing as allowed in for-profit entities engaged in similar activities. As for hospitals, Medicare and Medicaid federal rules require the offset of advertising revenues with direct expenses and allocated costs, and it seems inappropriate for two branches of the federal government to have different rules for the same activity.

II. CONVENIENCE EXCEPTION

PROPOSED ACTION: Repeal convenience exception. Income from activities that are substantially related to the organization's exempt purpose remain tax free subject to the specific rules listed in Section I.

COMMENT TO WAYS AND MEANS: We recommend that the convenience exception be retained. At universities and colleges many students, in order to afford their education, do not have use of automobiles, and failure of the universities and colleges to conveniently provide various goods and services would place an undue burden on the students. At hospitals, many activities undertaken for the convenience of patients, visitors and employees are inseparably linked to the organizations exempt purpose. Eliminating the convenience exception for hospitals would burden the organizations attempt to render charitable services and would place an undue hardship on patients, visitors and employees.

III. "REGULARLY CARRIED ON" RULE

PROPOSED ACTION: Repeal present law exception for unrelated trade or business merely because the business is not regularly carried on. Apply UBIT to any unrelated trade or business activity regardless of frequency conducted.

COMMENT TO WAYS AND MEANS: We support the stated option.

IV. ROYALTY EXCLUSION

PROPOSED ACTION: Apply UBIT to 1) royalties that are measured by net or taxable income, or 2) if the royalties are received by an organization for property created by the organization or developed and marketed at substantial cost to the organization.

COMMENT TO WAYS AND MEANS: We strongly recommend against taxing royalties that are received by an organization for property created by an organization or developed and marketed at substantial cost to the organization. This apparently would tax royalty revenues received by universities and colleges that result from licensing patents and software. This proposal is contrary to all of the government's interests in transferring technology from universities, colleges and research institutions to the private sector. This proposal runs contrary to all of the significant and productive federal initiatives encouraging universities to engage in technology transfer, e.g. P.L. 96-517 and P.L. 98-620. The implementation of this proposal represents a step backwards for technology transfer in the United States and can only have an adverse effect on our country, especially considering the overall concern for American competitiveness. It should be noted that foreign firms and inventors were awarded 47% of the patents issued in the U.S. in 1987. This represents a 10% increase over the previous ten years. Since passage of P.L. 96-517, universities have dramatically increased there level of patent and licensing efforts, e.g., prior to P.L. 96-517, the University of Michigan had one or two patent applications pending; we now have approximately 70 patents pending. This increase is a direct result of encouragement by the federal government for universities to get involved in technology transfer and take risk.

The risk involved in patenting and licensing the results of basic research as performed in universities is significant. University efforts to market and commercialize the results of basic research are considerably more speculative and difficult than the patent and licensing endeavors typical of the commercial sector. Yet it is the "basic" nature of university research that can result in new industries, e.g., biotechnology. To stay involved in technology transfer, universities need encouragement to take a long-term view.

We believe most universities feel that the federal government has encouraged them to invest resources in technology transfer as a valuable public service. It is viewed as universities doing their part to assist the federal government in converting research dollars into potential economic resources. The threat of taxation of royalties is a significant cloud over university incentives to stay involved.

As to the proposal to tax royalties that are based on net or taxable income, we have no great objection to this.

V. DEDUCTION FROM TAXABLE UBIT

PROPOSED ACTION: Increase the $1,000 deduction to $5,000 or $10,000.

COMMENT TO WAYS AND MEANS: We support the stated option.

VI. UNRELATED DEBT-FINANCED INCOME/FINANCING ARRANGEMENTS

PROPOSED ACTION: Limit the current law UBIT exemption for income from debt/finance transactions to only those transactions where the participating pension funds, educational institutions and title/holding companies make at least a 20% equity contribution of their share of the property acquired to such debt/finance transactions not related to their function.

COMMENT TO WAYS AND MEANS: We support the stated option.

VII. TAXABLE SUBSIDIARIES AND JOINT VENTURES

A. Definition of Control

PROPOSED ACTION: Change the definition of control in the case of taxable subsidiaries to ownership directly, indirectly, or by attribution of at least 50% of the stock by vote or value.

COMMENT TO WAYS AND MEANS: We support the stated option.

B. Taxation of For-Profit Subsidiaries

PROPOSED ACTION: Provide that a controlled taxable subsidiary's taxable income can be no less than its UBIT would have been if it were still in parent exempt organization.

COMMENT TO WAYS AND MEANS: We disagree with this, in that it goes against the basic concepts of corporate environment by not allowing the offset of losses against gains.

C. Aggregation

PROPOSED ACTION: Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of organization is a tax-exempt purpose.

COMMENT TO WAYS AND MEANS: We recommend this not be enacted.

VIII. ALLOCATION RULES

PROPOSED ACTION: Eliminate deduction of overhead and depreciation for unrelated business activities.

COMMENT TO WAYS AND MEANS: We recommend that the allocation of depreciation and overhead expenses to UBIT activities be allowed to continue. The elimination of these deductions to UBIT activities is discriminatory. If an activity is deemed commercial-like, then both for-profits and not-for-profits should be able to calculate costs in a like manner. The problem stated relative to this option, is that "The Treasury Department states that the proper allocation of expenses between related and unrelated businesses is one of the most difficult issues that arises in determining the amount of unrelated business income." Rather than disallowing the allocation of these expenses, the rules as to allocation methods should be tightened, and detailed disclosure of allocations methods should be required, allowing IRS desk audit of these methods. In the case of hospitals and research universities, the allocation of these expenses is not a difficult one, because of federally mandated allocation rules. Hospitals use Medicare and Medicaid federal Department of Health and Human Services cost allocation rules. Research universities use allocation rules from Circular A-21 (research) and A-110 (state governmental contracts).

IX. TAX INFORMATION REPORTING/IRS ADMINISTRATION

PROPOSED ACTION: Expand Form 990-T reporting or similar requirement to state instrumentalities.

COMMENT TO WAYS AND MEANS: We agree with the concept of universities that are state instrumentalities providing information reporting. However, in order to ensure meaningful reporting, we suggest that the National Association of College and University Business Officers be involved in the development of the reporting requirements.

X. MISCELLANEOUS OPTIONS

A. Social Clubs

PROPOSED ACTION: Codify position reflected in Revised Ruling 81-69 which provides that a social club may not, in determining UBIT, reduce its net investment income by losses of sales of food and beverage to nonmembers.

COMMENT TO WAYS AND MEANS: We support the stated option.

B. Financing Arrangements

1. Rental Income from Prime Tenants

PROPOSED ACTION: Exempt from UBIT an organization's contingent rental income received through a prime tenant.

COMMENT TO WAYS AND MEANS: We support the stated option.

2. Treatment of Commitment Fees

PROPOSED ACTION: Exempt from UBIT investment income earned from nonrefundable loan commitment fees.

COMMENT TO WAYS AND MEANS: We support the stated option.

C. "Testing for the Public Safety" Exemption

PROPOSED ACTION: Modify rules applicable to organizations exempt under 501(c)(3) as organizations "testing for public safety" such as creating new exempt category outside of section 501(c)(3) or applying UBIT to certain routine testing activities that currently qualify as public safety testing.

COMMENT TO WAYS AND MEANS: We recommend that the provisions allowing exemption from UBIT for public safety testing not be narrowed.

D. Piecemeal Exclusions of Certain Activities

(a) PROPOSED ACTION: Apply UBIT to income from the distribution of any article including low cost items, incidental to the solicitation of charitable contributions (Repeal provision enacted in the Code in 1986; in regulations pre-1986.)

COMMENT TO WAYS AND MEANS: We recommend that the provisions not be repealed. The competition with small business, if any, is only nominal. The tax revenues that would accrue to the federal government would be nominal, and not justify the additional paperwork. The likely result of such a rule change would be either i) the elimination of contributor incentives put forth in the annual pledge drives with the potential of lost donor interest or ii) greatly increased record keeping.

(b) PROPOSED ACTION: UBIT would apply to income received from the exchange and/or rentals of membership or donor lists among 501(c)(3) organizations. (Repeal provision enacted in 1986)

COMMENT TO WAYS AND MEANS: We support the stated option.

(c) PROPOSED ACTION: UBIT would apply to income generated from gambling activities, games of chance, bingo and other such games (repealing provisions enacted in 1978, 1984, and 1986).

COMMENT TO WAYS AND MEANS: We support the stated option.

(d) PROPOSED ACTION: UBIT would apply to income on the lease of the right of-way to use telephone lines, telephone poles, etc. (Repeal provision enacted in 1980)

COMMENT TO WAYS AND MEANS: We support the stated option.

(e) PROPOSED ACTION: UBIT would apply to income earned by a hospital for providing services such as data processing, record keeping, laboratory work, etc. to another not-for-profit hospital with less than 100 patients (Repealing provisions enacted in 1976).

COMMENT TO WAYS AND MEANS: We do not agree with this section. We believe the public would be better served if medical costs could be reduced through elimination of duplicate services. Especially in rural settings, there may be no entity knowledgeable in hospital services other than another hospital. Even in urban areas, specialty medical services are often not available locally other than from another hospital. Therefore, we recommend continued exclusion from UBIT of income of this nature.

(f) PROPOSED ACTION: UBIT would apply to income of certain trade shows, state fairs, etc. including convention and activities of a qualifying organization (Repealing provisions enacted in 1976 and expanded in 1984).

COMMENT TO WAYS AND MEANS: We recommend that existing provisions not be repealed.

(g) PROPOSED ACTION: UBIT would apply to certain income used by labor, agricultural, or horticultural organizations to establish, maintain, and operate a retirement home, hospital, etc. where the income is derived from agricultural pursuits on grounds adjacent to the organization's facility.

COMMENT TO WAYS AND MEANS: We support the stated option.

(h) PROPOSED ACTION: UBIT would apply to income from universities' commercial radio stations.

COMMENT TO WAYS AND MEANS: We recommend that existing provisions not be repealed, except that commercial stations, even if owned by a not-for-profit entity, should be taxed. It is our opinion that commercial radio and television stations should be taxed, even if they are owned by a not-for-profit organization. Public radio and television stations should not be taxed. Public stations being defined as a qualified public radio or television station as defined by the Corporation for Public Broadcasting and the Federal Communications Commission. The main difference between a commercial and public station is that a public station may not advocate the sale or use of any products or services.

THE UNIVERSITY OF MICHIGAN
ANN ARBOR 48109-1340

RICHARD L. KENNEDY
VICE PRESIDENT FOR GOVERNMENT RELATIONS
AND SECRETARY OF THE UNIVERSITY

May 18, 1988

The Honorable J. J. Pickle
U.S. House of Representatives
242 Cannon House Office Building
Washington, D.C. 20515

Dear Congressman Pickle:

The American Society of Travel Agents, Inc., (ASTA) made a serious error in its May 9, 1988 statement to your Subcommittee regarding The University of Michigan.

The statement reads on page five "...No longer should a university like The University of Michigan be allowed to conduct up to 32 different world-wide tours for its alumni and the public, and not pay taxes on its profits."

Attached is a copy of a letter from Mr. Robert Forman, Executive Director of The University of Michigan Alumni Association, to Mr. John C. Bennison of ASTA pointing out the gross inaccuracy contained in the ASTA statement. I ask that Mr. Forman's letter be included in the record of proceedings of the hearing immediately after the ASTA statement.

Mr. Chairman, the Alumni Association of The University of Michigan, an independent organization, as well as the University itself, has filed 990-T forms for years. The Alumni Association pays UBIT on its travel activities. Indeed, additional profits made are those by ASTA members who provide services to the Association.

The University of Michigan Interim President, Robben W. Fleming, in his April 20 letter to you stated that the University supports the option to "apply UBIT to income for all travel and tour services except those provided for faculty and students as part of a curriculum in their degree program."

We commend your efforts to review UBIT and will appreciate your effort to include Mr. Forman's letter in the record so that we too are treated fairly.

Sincerely,

Richard L. Kennedy

RLK:g

Enclosure

cc: R. W. Fleming
R. Forman
T. Butts
S. Levin
G. Vander Jagt

The Alumni Association of The University of Michigan
Alumni Center / 200 Fletcher Street / Ann Arbor, Michigan 48109
(313) 763-2452

18 May 1988

Mr. John C. Bennison
Vice President
Government and International Affairs
American Society of Travel Agents, Inc. (ASTA)
P. O. Box 23992
Washington, D. C.   20026-3992

Dear Mr. Bennison:

I have examined a copy of the May 9, 1988 statement that Earlene L. Causey presented to the House Ways and Means Committee, Subcommittee on Oversight, chaired by the Honorable J. J. Pickle. The statement was on behalf of the American Society of Travel Agents, Inc. (ASTA). You are listed as the contact person. The next to the last paragraph of the five-page statement contains the following sentence:

> "No longer should a university like The University of Michigan be allowed to conduct up to 32 different world-wide tours for its alumni and the public, and not pay taxes on its profits."

This statement is completely inappropriate and contrary to fact. The University of Michigan does not conduct world-wide tours. The Alumni Association of The University of Michigan, a separate legal entity incorporated in 1897, operates educational travel programs for its members. The following observations correctly represent the Alumni Association travel program:

1. Since 1977 the Alumni Association has treated travel income as unrelated business income. We annually file an Exempt Organization Business Income Tax Return (Form 990-T) and pay the appropriate tax.

2. The Alumni Association operates travel programs for its members and promotes such programs only to that membership -- not the general public.

3. The Alumni Association mails all travel communications and promotions at commercial mailing rates.

4. The Alumni Association employs the services of ASTA-member travel agencies.

5. The Alumni Association travel program is totally self-supporting. Neither membership dues nor any other Alumni Association income is used to subsidize the cost of the travel program.

Mr. John C. Bennison
18 May 1988
Page Two

The University of Michigan, in an April 20, 1988 letter from Interim President Robben W. Fleming to Chairman Pickle, recommended that such travel activities be viewed as unrelated business. This is a position that the Association has adhered to for ten years.

The Alumni Association, in light of the obvious discrepancy between fact and the statement made by ASTA, expects an immediate retraction of the statement, an apology rendered to The University of Michigan and The Alumni Association of The University of Michigan, and a corrective entry into the records of the Oversight Committee hearings.

I await your immediate reply.

Sincerely,

Robt G Forman

Robert G. Forman
Executive Director

:kmh

cc: Honorable J. J. Pickle, Chairman, House Oversight Subcommittee
Robben W. Fleming, President, The University of Michigan
Judge Geraldine Bledsoe Ford, President, Alumni Association
Richard L. Kennedy, Vice President for Government Relations, The University of Michigan
John D. Ketelhut, General Counsel, The University of Michigan
Earlene L. Causey, President, V.I.P. Travel Agency
Appropriate ASTA-member agencies